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IMPACT OF THE PRESIDENT'S 1987 BUDGET

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 7, 18, 19, 20, 21, 25, 26, AND 27, 1986

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IMPACT OF THE PRESIDENT'S 1987 BUDGET

FRIDAY, FEBRUARY 7, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:42 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The CHAIRMAN. The committee will come to order.

Certainly, we want to welcome all the members of the committee back to this very important session, the second session of the 99th Congress, as we begin our deliberations officially with regard to the President's fiscal year 1987 budget.

The Budget Committee is pleased to welcome this morning Secretary of Defense Caspar Weinberger, and Chairman of the Joint Chiefs of Staff, Adm. William J. Crowe. We are pleased that you could be with us for what is the committee's first hearing on the fiscal year 1987 budget and what will be, I am sure, a most important hearing.

This is a critical year for the Federal budget, most certainly for the Pentagon budget. The enactment of Gramm-Rudman could mean drastic reductions to defense funding for fiscal year 1987, with little regard for priorities or effects on national security. The President may choose to deny this. His denying reality only means that Congress must play an even more major role in establishing our national security agenda.

Mr. Secretary, let me assure you I, for one, do not want to see sequestration. This would be a disaster for our national security as well as some of our domestic priorities. I do not want this to happen.

The administration maintains, of course, that all Congress has to do is rubberstamp the budget just sent to us which calls for 12 percent growth, or $34 billion increase, in fiscal year 1987 in the Pentagon budget. Let me assure you that there will be a fair hearing and a vote in the House on the President's budget as submitted and requested by Mr. Miller and Mr. Baker.

If necessary, Congress will take the lead in fashioning a budget that will balance our domestic and defense needs within the constraints of a very confined fiscal environment.

Early on, it is important that we clarify the various accounting on technical budget issues such as the previous year's base. Too often the confusion over these kinds of issues has focused the debate away from the more important substantive issues, such as the appropriate level of Pentagon funding, and which are valid pro-

grams. This year we have even less time to be sidetracked by these kinds of things.

A particular issue which concerns me this year is an apparent shortfall in Defense Department outlay estimates as submitted by OMB. It appears as though the Pentagon, or OMB, has understated fiscal year 1987 outlays by as much as $15 billion. If this is true, the administration's deficit is not $143.6 billion, but at least $159 billion. This does not meet the deficit level required by Gramm-Rudman. I hope we will be able to shed some light on this apparent discrepancy this morning.

Our national security is too important to be compromised by any games that might be played with Gramm-Rudman. All of us, Democrats and Republicans, liberals or conservatives, want to do whatever is necessary to provide for national security. We, in Congress, and this committee in particular, intend to participate in a positive way toward establishing our national security agenda.

The sea of red ink which we face is a crisis of staggering proportions. The size of the deficit threatens our national security as much as do enemy bombers and missiles. We recognize the Soviet threat and the fact that we live in a dangerous world. However, we must also recognize the economic threat of this deficit. We cannot have true national security without economic stability.

We would like to begin the process this morning. Mr. Secretary, thank you for coming before the committee once again. We are looking forward to a candid exchange of views with you on important defense issues. While we have not always agreed with you, we do admire your tireless and sincere efforts on behalf of the administration and the Nation.

Admiral Crowe, we congratulate you on your promotion to Chairman of the Joint Chiefs and welcome you to the committee for the first time. You have assumed your important post at a very critical moment. We are confident that as the Armed Forces' senior military official, your wise and experienced counsel will prove useful to the Secretary and President. We hope that this committee and Congress will also be able to benefit from your vast knowledge of national security issues and that there will be a free exchange of information.

Mr. Secretary, Admiral Crowe, would you please proceed with your short summary of your testimony. We have your complete testimony which will be entered into the record. However, we hope that you will be able to summarize briefly that testimony so that we may get into a candid and frank exchange of views.

However, prior to your beginning I would like to call upon the gentleman from Ohio, Mr. Gradison, who is acting as the ranking minority member, for opening comments. As we all know, our ranking minority member, the distinguished gentleman, Mr. Latta, is unfortunately hospitalized and we are concerned about his condition. Our prayers are with him and his family. He cannot be with us. However, we look forward to Mr. Gradison for the leadership that we know he has so expertly provided through the years on budget and economic issues.

So we would like to begin first, Mr. Secretary, before your summary, with an introductory comment from our ranking minority

member today, Mr. Gradison; and then an opening comment from our majority leader, Mr. Wright.

Mr. GRADISON. Thank you, Mr. Chairman.

It took a combination of a recess and a snowstorm to move me temporarily into this position, and I certainly will not overdo my brief elevation to the purple.

Mr. Chairman, Mr. Secretary, this is our first hearing that the Budget Committee has held this year on any subject. I think it is appropriately so that we begin with the Department of Defense. Once we look over the budget and agree, as I think we must, that it must be approached with an assumption that there be no new taxes as a basis for dealing with the budget, once we look over the budget and accept the congressionally mandated target of a deficit of no more than $144 billion, it seems inevitable that we are going to have to focus on your department, since it appears to be the largest one with substantial increases, and therefore, requires our very careful examination.

With Gramm-Rudman on the books, a bill which I imagine you have mixed feelings about but which was signed by the President, we have a new ball game assuming that this bill holds up in the courts.

I would say, in agreeing with my chairman, that about the worst thing that could happen to your department and to the defense of the Nation would be to have the Gramm-Rudman-Hollings across-the-board cuts take place in October. We have to find a way to do better than that.

Mr. Secretary, the whole process here on the Hill this year is going to be frontloaded, by which I mean that decisions are going to have to be made earlier than normal because of the impact of Gramm-Rudman. We are supposed to complete action on the budget resolution in both Houses by April 15. All appropriations on the House side are supposed to reach the floor some time in June.

What that says to me, Mr. Chairman—and this may be more hope than anything else—is that I hope we can move in this hearing today past the usual fixed positions which have characterized a lot of our hearings and meetings with the Defense Department in the past. I mean fixed positions on both sides of the table, which in my judgment have produced a lot more heat than light, and move quickly to a position where we can take action and reach compromises. It is only with compromises that we will be able to protect the national defense and also meet the budget targets which have been laid upon us by the provisions of the law.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Gradison.

Now we would like to have the distinguished majority leader from Texas, Mr. Wright, to have some opening remarks. He has a clipped wing, and we are just delighted that he is able to be with us today.

Mr. WRIGHT. Well, thank you, Mr. Chairman.

The Secretary and I are old friends. I recall the days when Secretary Weinberger was Director of OMB, pinching pennys, and those days they called him Cap the Knife. Since he has been over at the Pentagon shoveling out the cash, folks are calling him Cap the Ladle.

I am anxious to express to the Secretary some of the concerns that we have. I know his deep devotion to the national defense of our country, and that we admire and respect and applaud.

I think it has to be viewed, however, at this moment in the context of what we have seen happening in these last 5 years. During the past 5 years, we have taken actions at the request of the administration which have reduced revenues coming into the Government by approximately $1 trillion. By the end of this year, we will have siphoned away some $1 trillion in tax cuts that otherwise would have come into the Treasury.

While doing that, we will have added approximately $500 billion in new and additional Pentagon spending above the 1980 level. You add those two figures together cumulatively, you come to the inescapable conclusion that the military spending buildup along with the reduction in taxes together have exerted an influence of some $1.5 trillion upon deficits.

We just can't go on indefinitely on a credit card binge buying every weapon that we find attractive and desirable and putting it on the bill for our children and our grandchildren to pay.

We have just about doubled what we are spending in military strength since 1980, and in that year outlays were $146 billion. That, incidentally, was the biggest sum that ever had been spent in any given year for the military.

This year, we are spending $296 billion, more than twice as much. Meanwhile, we shall have reduced discretionary domestic expenditures by approximately 34 percent on a current services basis. So, if we were to wipe out discretionary domestic expenditures entirely, we couldn't make up the difference that has been made by the cumulative effect of increased military spending along with decreased taxes.

Now, we notice that you are asking for $320 billion next year in budget authority. That represents a $34 billion increase over the current year, or an increase of some 12 percent in dollars, or some 8.2 percent, indulging the administration's own assumptions of the effect of inflation; in real growth, 8.2 percent real growth after adjusting for inflation.

I think you must realize most assuredly that at a time when we are being asked to cut back on so many other things and even to eliminate some services that the American people find beneficial and helpful, some regard as necessary to their well-being, it is very, very difficult to justify continued uninterrupted growth of this magnitude in military spending.

The American people, I think, Mr. Secretary, are perfectly willing to pay for an adequate national defense. They are willing to pay for what we need when we need it. I don't believe that they expect their Congress to continue putting it on a credit card and charging it to their grandchildren or their children to pay for things that we will have used up and worn out before they reach taxpaying age.

During the Korean war, President Truman conducted that entire enterprise without adding to the national debt, the second or third most costly war in our Nation's history. We didn't add to the national debt. We paid as we went. That is patriotism.

I think the American people are willing to indulge that kind of patriotism to pay for the national defense we need when we need it in our time rather than expecting another generation to have to pay for those things that we will have dissipated.

Even during the costly Vietnam war, during the tenure of President Johnson, and his predecessor and successors, Presidents Nixon and Ford, we didn't just add and pile up debt for our children to pay. We paid largely as we went. So there is an inescapable connection that we have to face.

I mention these things to you because I think you really have to realize that Congress, as determined as we are to provide a sufficient level of national defense, also is determined not to pile upon our children's backs the responsibility to pay for those things that won't be around for them to enjoy when they reach taxpaying age. So, all things are going to have to stand the test of austerity.

I noticed in the morning paper, the paper quotes you, Mr. Secretary, as having said that your agency based this 12 percent increase that you are asking for on a long-term defense contract estimate and annual spending rates contained in the budget resolution approved by Congress last year.

Well, of course, budget resolutions from year to year look out to the future and try to forecast what we expect to be able to spend. But there is nothing unchangeable about them. We have to review them from year to year in light of existing circumstances, and one of those existing circumstances, of course, is the often pronounced and joyfully proclaimed unwillingness of our President to indulge any consideration of revenues for the purpose of deficit reduction.

It is perfectly all right to raise some people's taxes if you cut other people's taxes. Fine. It is all right to raise user fees and things like that and not call them a tax. That is fine. But it is not all right to have any revenues coming into the Government for the purpose of reducing these enormous deficits. And in light of that, of course, we have to reexamine everything.

If we were to assume that the amount that had been forecast in previous budgets for future years were sacrosanct for the military, they would have to be sacrosanct for every other activity of the Government, as well. If we assumed them to be sacrosanct for every activity of the Government, then there wouldn't be any way, any way at all, that we could achieve our deficit reduction goals. We are determined to achieve them by one means or another.

With those thoughts in mind, Mr. Secretary, we surely do hope that you will examine with a very, very careful eye—hone down the experience of "Cap the Knife"—the budget that you submit, and pare it, and make it austere, and in every way responsive, and responsible to achieving a dollar's worth of defense for a dollar's worth of taxes.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Majority Leader.

Mr. Secretary, welcome. Admiral Crowe, welcome. We invite you to give us a summarization of your testimony so we can move into the question and answer period. Please proceed, Mr. Secretary.

STATEMENT OF HON. CASPAR W. WEINBERGER, SECRETARY OF DEFENSE

Mr. WEINBERGER. Thank you, Mr. Chairman.

It is always a pleasure to be here. I had planned to summarize my statement. I had planned to devote it entirely to the defense program, given the reasons why we have come in with the requests that we have, and try to move the debate away from simply a question of percentage increases and real growth, and top lines and bottom lines. I wanted to get to a discussion of why the defense budget is where it is, what it contains, and why we feel it has to do that—in other words, discuss purely the substance rather than just the formalistic consideration of percentages, and real growth, and so on.

The majority leader's statement, however, has moved me to devote a little time to those latter and, as I see them, less important issues from the point of view of our security. I would just say at the beginning that the knife has been applied very severely to the requests that we received from the services, and the services, of course, would confirm that. After very careful consideration of the Nation's needs, based on their expertise acquired from a lifetime spent in the service, and with full appreciation of the risks to the Nation—which have not diminished in any way in the last few months—they brought in requests that we found it necessary to pare back very substantially. And we did that.

That is what is before you. It is not an opening overbudget or anything of the kind; it is a budget that carefully reflects the needs of the Department—carefully considered, carefully stated, and reduced substantially from what is required by our commitments and by the risks that the Nation faces.

I was very interested in the majority leader's statements about how drastically revenues had been cut, and I wanted to put a few figures before you because I think it is important that you have those figures.

Since the end of fiscal year 1980—and bearing in mind that the President's tax cut didn't take full effect until a year or so later—with that tax cut, not despite it, because we think because of that tax cut the revenues of the Federal Government of the United States increased $217 billion in that 4- or 5-year period, a 42-percent increase. We think it is a result of the tax cut.

It buoyed the economy, some people say, some people say despite the tax cut. One way or another, 42 percent more revenue came in during that period.

The problem, of course, that we all face is that the expenditures went up $355 billion, or 60.1 percent during that same period. So although we got a great deal more revenue in, $217 billion, we spent a great deal more than that. And some of you will immediately say, well, that was all national defense, but the fact is it wasn't. Less than a third of that outlay increase was for national defense, about $118 billion. So actually somewhere around 28 or 29 percent of that increase was for defense.

We cannot, we think, be faulted in any way for causing the deficit with which we all have to deal. As a matter of fact, we have figures which will demonstrate that during the period of time

when everybody was trying to get hold of the deficit and was making reductions all the way through in defense, for example, fiscal year 1984, our outlays went down $10 billion from the original January 1984 estimate.

While we were doing that, the Federal Government deficit increased by about $2 billion from the estimate. In 1985, the figures were that we went down $19 billion, and the deficit went up almost $32 billion—$31.9 billion.

Then in fiscal year 1986 we went down $43 billion from the original estimate, but the deficit of the Government went up $25 billion. So what does that mean? What it means is that all of the deficit reduction that was obtained by defense was wiped out, and $25 billion more, for example, was added in 1986.

Without the defense reduction, the deficit would have been about $44 billion higher. So we feel we have contributed in a very major way to deficit reduction, but that nobody else has.

We think it is extremely important that we look at the needs we have and the risks that the country faces and stop considering just whether it is a 5 percent, or 6 percent, or whatever increase over last year. As a matter of fact, the majority leader talks about a $320 billion—our request is $311 billion. That $311 billion request is $3 billion less—$3 billion less than this committee and the Congress told us to bring in for 1987 just last August.

It seems to me that what we have requested, if we go $3 billion under—without any reduction in the risk, with the same kind of problems from the Soviets that we faced in August—is doing what we ought to be doing. So it is odd for us to be told that the committee's resolution last August didn't mean anything and we shouldn't pay any attention to it. We paid a great deal of attention to it. It stated the will of the Congress. It wasn't just this committee; it was enacted by the Congress.

We came in under that. We used the outlay numbers that this committee gave us, and we reduced those—those are only estimates, of course—we reduced those by a comparable amount when we came in with this year's budget. So we don't feel that in any way we are asking for either an excessive amount or an amount that has not already been scrubbed very thoroughly to get it just as low as we can.

There was a lot of discussion about how defense is being bought now on a credit card and the burdens of it are being placed on subsequent generations. Defense, Mr. Chairman, is 27 percent of the budget. If defense is being bought on credit card, how do you believe we are paying for the more than two-thirds of the budget that we keep on spending and increasing each year? That is going to be a pretty big credit card bill, and it is not just defense that is being put on anybody's future shoulders. It is the expenditures of the Government as a whole in a very much greater fashion than defense.

We are now at a far lower share of the gross national product than we were in the days of President Kennedy and President Eisenhower, and we are at a far smaller share of the budget than we were then. We are now at 27 percent of the budget, about 6 percent of the gross national product, and that is vastly lower than the 45 to 49 percent of the budget that defense was 30 years ago.

So, we are doing what we were told by this committee to do. We are doing a bit better, $3 billion better. Under those circumstances it is a little disconcerting to be told that despite the fact that nobody questions that the world situation has, if anything, worsened since that figure was given to us last August, somehow now we are asking for enormous and unnecessary amounts.

Certainly, it is disconcerting to be told that the congressional budget resolution doesn't mean anything and we shouldn't pay any attention to it; and instead of cutting it $3 billion, presumably we should cut it by $25 or $30 billion. I would venture to guess that if we did so we would then be told that what we really should do is cut it by $50 billion. And if we cut it by $50 billion, I have no doubt that a large number of people would say what you really need is to cut it by $75 billion.

So, I think what we ought to do is start with what the committee told us to do in August, look at the substance and ask if we had any reason whatever to make any drastic reductions in that because of improvement in the world situation. I have to say I am afraid the answer is no, there hasn't been any change. And for us to cut $3 billion under that congressional resolution seems to me to represent not only compromise but a moderate approach that recognizes that we have fiscal problems, but that we have to provide for the Nation's defense, and only the Federal Government can do it.

There are, however, a number of other points that I think we should make, and I have made them at substantial length in the opening statement which you have been kind enough to say, Mr. Chairman, can be incorporated in the record in full. I appreciate that.

There are a couple of things that I think should be brought out before you at this time, and I would like to do that now for just a few more minutes and then take your questions.

The first thing I think we should notice is that the defense budget, chart 1, represents a very substantial reduction from the original estimate.

We came in March 1981 with a 5-year plan as we were required to do, and that plan said that the 1986 authorization figure should be $367 billion. These are the figures within the red bar. With successive changes in that and with the success we have had in managing inflation we were able to make substantial reductions in that during the years through 1985.

The budget the President submitted is another $11 billion below that, and then in the course of congressional budget consideration, $24 billion more was taken off. Then the Gramm-Rudman application automatically came into effect the first year and dropped it another $11 billion.

That $11 billion takes it all the way down to the figure that is before you for 1986. That is the figure just enacted and now in the 1987 budget, chart 2. What we request is to carry out and, in a sense, make honest the compromise reached between the President and the Congress, embodied in the congressional budget resolution of August, that we should have zero real growth in 1986 and 3 percent on top of that in 1987 and 1988.

Unfortunately, 1986 did not come out to be zero. It came out to be minus 6. The budget that is before you represents a 3-percent real growth over 1985, 3 percent real growth over what would have been zero for 1986.

As you will see, the figures there are the $311 billion I mentioned before as against the $314 billion that was in the budget resolution, which this committee and the Congress approved just last August.

I spoke about the threat not diminishing, and chart 3 is an attempt to present to you some of the dimensions of that threat.

These are the selected weapons systems that the Soviets and the Warsaw Pact forces have acquired as opposed to the NATO forces and the United States over the period from 1975 to 1987. You will see that in every single category except major surface warships the Soviets have outproduced us by a very substantial amount.

That raises the point, Mr. Chairman, that the important thing to bear in mind here is not really so much the top line, or the percentage growth, or real growth, or nominal growth; it is what do you get for it?

This is what the Soviets got for it, and this is what we had for ourselves during that period.

The next chart, chart 4, will also show what is in our budget this year compared with the average annual output of the Soviets and ourselves over the past 5 years.

Their average, annual output for some of these systems and for many, many more has been vastly in excess of ours, again, except for surface combatant ships.

Even the amounts that we have in the budget this year, that everyone says are too high, will certainly not get us, in any sense, any kind of superiority or anything of that kind with Soviet acquisitions during that same period.

Manpower is our highest priority, and manpower we were able to protect under Gramm-Rudman—this year and this year only.

We can't do it next year. There is a request for an increase this year. It is a modest increase of $14,000; $12,000 of it goes to the Navy, because as we authorize, build, and take delivery of ships, they do have to be manned. That is the manning request for those additional ships. The other services are held pretty level, but that is the $14,000 increase we requested for 1987.

Bear in mind what would have happened in 1986 if Gramm-Rudman had not had a 1-year exemption for military personnel. We used that; we treated it as our highest priority as we always do, our manpower and our personnel, and so we didn't make reductions in those personnel accounts. We had to make them in other accounts.

But by not making those reductions—by taking advantage of the one-time Gramm-Rudman exemption—we saved ourselves and the country from having to put 280,000 people in the active service out on the streets within the month.

That would have been a disaster for the military. It will be much worse than that next year if the Gramm-Rudman trigger is pulled, because under the existing law we won't have a personnel exemption next year.

The quality of the people we are getting is very high. The All-Volunteer system is working extraordinarily well, and you see in chart 6 that the recruits are now 93 percent high school graduates. The second part of that chart shows that first-term reenlistments are falling off a bit, because, I think, of the improved economic climate, but also because of the perceived, correctly perceived, turbulence in the funding for national defense—the question of whether or not the Congress is going to continue to display the generosity and the cooperative recognition of the threat we face that they have done in the past 5 years.

We make full use of our Reserve and Guard components, and they are an important part of the program. The degree to which we would rely on them is shown by chart 7, and we also have the various modern weapons systems shown here as going to the Guard and Reserve.

Chart 8 shows an important part of our total force structure, and it is important they get the most modern, technologically superior equipment as it comes on line for the Active Forces.

A lot of people have said that we haven't received enough for the amount that has been spent. Chart 9 shows what we did get and from what kind of a base we had to start in 1980. As you will see by the second column, by fiscal year 1985 those were the things that had been added to the Army Forces—tanks, Bradley fighting vehicles, helicopters, missiles, and the NATO-sponsored MLRS Artillery Program.

The third column is an important one, because those are the things we have already had authorized and appropriated, which are in the pipeline and will be delivered.

Then the 1987 request for all these items is shown in the last column. It is important to know this because frequently people try to take a snapshot at a given time and say, you have not gained this much or haven't done enough and the gap is still there with the Soviets.

It is important in doing that to bear in mind what is in the pipeline. It is also important to bear in mind, as the chart illustrates, what a long period of time it takes to regain momentum after you come out of a period in which you have had a real decline of 20 percent, as we did during the 1970's.

Next, chart 10 shows the same modernization—what we have obtained during the 5-year period for the Navy and the Marine Corps. And you will see the additional ships that have been built in that period of time, 18 submarines, and over 40 frigates, and so on.

But then the next to the last column is also important because it shows all those that have been authorized and appropriated, and will be delivered.

The final column shows the small numbers that we are requesting in the 1987 budget.

Chart 11 is the same chart for the Air Force showing again the planes and missiles that have been acquired by the Air Force and the difference in inventory between 1980, when we came into office and the present time.

In chart 12, you see the Special Operations Forces, unfortunately a highly necessary force in the climate in which we exist. These are the things that we have added to that. These forces, under uni-

fied command, engage in a substantial amount of joint operations, and involve specialties that individual service contributions are bringing to this force.

Research and development is also a critically important part of the defense budget in maintaining the technological edge that we have to have. It is our principal advantage, because we do face very large imbalances in conventional weapons and manpower, and so we rely heavily on our research and development.

Chart 13 shows the degree of priority that we attach to the strategic defense initiative as well as to development of other new and extremely important weapons systems on which we are working.

We have also had a major increase in readiness during this period. That shows up in one of the most important, critically important indices of readiness and sustainability; and that is ammunition.

Chart 14 shows in percentage form the increases in our ammunition reserves and supplies even after a very high operating level of exercises, which we now have as a result of placing a very high priority on this ammunition item.

Chart 15 is part of readiness, it is the number of tactical flying hours, steaming times, and the number of battalions that we have been able to put through the new military training center at North Irwin. This is an important part of readiness, and I am very happy to see the increases that have occurred during the past few years in all these areas, because that, again, is an index of our increased readiness.

In all of this we have had a substantial concern, as we had to have, for better management. The figure at the top of chart 16 shows, I think, one of the most impressive and heartening statistics of all.

We used to hear a great deal about cost overruns of major weapons systems, when we came into office. The cost growth for major weapons systems at the end of 1980 was averaging 14 percent a year.

Some years before that it had been as high as 17 percent a year. For the last 2 years, Mr. Chairman, it has been at less than 1 percent, and it will be in that same range for 1985. This is a major improvement in management brought about by vastly increased use of competitive contracts.

We now compete 72 percent of all of our contracts. By much better management of the execution of the contracts and a spare parts acquisitions, and by using economic rates of production, we have had savings now of over $2 billion.

Those are valuable ways to get us more defense for each dollar than we were able to do before.

The final chart, 17, shows some of our efforts to curb waste and fraud, and these are reflective of the enormously increased audits, investigations, and examinations that we have made to stop these problems that we found when we got here. This gives you a rough idea of the savings involved here. We estimate savings from contract audits in fiscal year 1985 at $8.1 billion, and with internal audit of DOD activities indicating savings of $2.7 billion.

Our investigative activities have resulted in fines and a number of restitutions and recoveries, which together have given us $126 million over this period of time.

Those are the charts that I wanted to present to you. I would like to call your attention, Mr. Chairman and members of the committee, to a very serious problem that we face. While it is completely within the purview of this committee, it is necessarily a matter of substantial interest to everybody, and that relates to retired pay.

The 1986 authorization bill directed us to submit legislation that would achieve a $2.9 billion savings in retirement, and meanwhile, it put a cap on the number of personnel that we could retain, and the amount of money we could expend from the personnel accounts.

They said that this would stay in effect until—or until the Congress passed retirement legislation by May 1 of this year, and then we would either use the new legislation or we would keep the authorization-appropriation caps on the personnel accounts in force.

So the result of that, Mr. Chairman, is that if the Congress does not enact the retirement legislation or lift the caps on the personnel account, we will have to let go from the active service before the end of this current fiscal year, 330,000 active people or 176,000 reserves.

That, again, would be not only a terrible thing for the military and for the security of the United States, but it would also cause a great deal of disruption and turmoil in other areas to put that many people suddenly out without positions and all the incident additional costs that that would be to the Federal Government, totally aside from the security considerations, which are massive.

Those are things that we hoped the Congress as a whole will deal with, and we hope that they can deal with them soon.

I would only conclude, Mr. Chairman, by saying that the budget before you is $3 billion less than the budget you told us to bring in. Conditions have only worsened since that time. It is, I think, reflective of an interest that is much greater in deficit reduction than in the security of the Nation if we continually say that no matter what level the defense budget is, it always has to be reduced, and if we fail to take any consideration of the problems, the actual condition of the world, the security needs of the United States, and the reason for a defense budget in the first place.

Thank you very much, sir.

[Testimony resumes on p. 62.]

[The prepared statement of Mr. Weinberger, with charts, follows:]

PREPARED STATEMENT OF HON. CASPAR W. WEINBERGER

Introduction:

This is the sixth time I have appeared before the Congress to present the Administration's request for resources to ensure that the national security interests of the United States are protected. During the previous five years, the Congress and the Administration have shared the common goal of rebuilding our defenses to reestablish the balance of military power necessary for secure deterrence.

The product of that shared commitment has been impressive. Together, the Congress and the President have restored national pride, and international respect for the United States. The quality of the men and women in the military today has never been higher. American forces around the world are ready to respond to aggression. We are succeeding in getting large quantities of weapons deployed to our forces.

The political effects of this shared commitment are also evident. American resolve to resist aggression is evident; our alliance partnerships are stronger; and, an unwilling Soviet Union has been forced back to the arms negotiating table in the grudging realization that it will not be allowed to achieve military superiority over the United States and our allies. Further, the sequence of annual Soviet aggression against new targets that began in the mid-1970s with Angola, and culminated in the brazen invasion of Afghanistan, has ceased. Working together, the President and the Congress have come far in reversing a decade of neglect, restoring the deterrence balance, and updating our defense strategy and policy.

These are powerful and direct results of American resolve and commitment to bear the cost security requires. The responsibility to sustain these results lies before us as a continuing requirement. It is obvious that the FY 1987 defense budget represents a critical phase in the continuation of our shared goals and responsibilities. Shall we maintain our goal of rebuilding U.S. defenses or will we fall back and see this

effort falter? The Administration remains committed to the sustained improvement of U.S. national security capabilities. But that goal is threatened as the Congress' commitment to the priority of national security wavers.

Few dispute the risks we face today. Soviet military capability grows unabated as it moves to confront the United States throughout the world. Risks to regional stability abound -- even here in our own hemisphere. While the strategic and conventional challenge to our security continues, terrorism and low intensity conflict have emerged as additional risks with which we must contend. Yet, in the face of this situation, some individuals maintain that our defense efforts must now be relaxed -- not because the risk is diminishing, not because a modern and responsive military capability is unnecessary, but because it is asserted that the United States cannot afford an adequate defense.

I have never accepted this assertion, nor the peculiar belief that American politics require that military preparedness must suffer in equal measure with dams and mass transportation projects in times of fiscal constraint. Those who argue that we should forego a significant increase in safety must explain why.

The central questions each of us must ask are:

1. Are we, for any reason, prepared to cut American strength in ways that increase the risks of war? Those who judge that, in order to reduce the Federal deficit, the United States should underfund the program previously agreed to by the President and the Congress and run higher risks to our security should stand up and say so.

2. With arms reduction negotiations ongoing and the Second Summit near, is this the time to tie the President's arm behind his back, rather than strengthening his hand? Make no mistake, the critical variable in the Soviet Union's willingness to negotiate seriously, to accept reasonable agreements, and to comply with those agreements, is their judgment of what we will

do, if they don't. Who is prepared to take responsibility for undermining the Soviet Union's incentive to accept an agreement for real reductions in strategic nuclear arms?

3. Is America not safer than we were five year ago? Does anyone want to go back to the U.S.-Soviet relationship of the late 1970's? Is American strength not the price for peace?

Budget Realities and Defense Spending:

I fully appreciate the fact that we are preoccupied with deficits. I understand the pressures confronting the Congress. Controlling deficits by reducing those areas of Federal spending which are improper or unnecessary is a goal I have always supported. Consequently, the Department of Defense has striven to take advantage of every opportunity to hold down defense costs through good management and contracting. In this regard I believe that defense has a good record if anyone will look at it.

Defense and Deficit Reduction:

Defense spending has been a continual contributor to deficit reduction exercises. Since transmittal of the President's FY 1985 budget in January 1984, defense budget authority and outlays have been reduced by $328.7 billion and $291.1 billion, respectively. Good management and the President's success in controlling inflation have enabled us to preserve force modernization despite these reductions -- which have often been the only real reductions in spending the whole budget process has sustained.

There are those who seem to insist that the only acceptable evidence of defense participation in deficit reduction efforts is the cancellation of a needed defense program. The Department of Defense has been a victim of its own success in keeping programs on track while making do with less. The results of better management have been labeled as proof of waste and

overbudgeting by those who would rather see public support for the President's defense initiatives fail.

The defense budget has become the target of opportunistic demagoguery, and our security has suffered. Prior to the application of the Gramm-Rudman cuts, the FY 1986 enacted defense budget represented a $24 billion reduction from the President's request. After absorbing the additional Gramm-Rudman-required reductions of $11 billion, the FY 1986 defense budget will represent a 6.2 percent real decline - the first time in 15 years that there has been an absolute decline to the defense budget below the previous year. One looks in vain to discover just what reduction in the risks we face occurred last year to justify this approach.

FY 1987 Department of Defense Budget:

Nonetheless, the Department of Defense (DoD) is keeping faith with the 0-3-3 percent real growth budget plan which the President and the Congress negotiated and which the FY 1986 Budget Resolution specified for national defense; just as in previous years we have conformed our requests to congressional agreements.

The President is requesting $311.6 in budget authority (BA) and $274.3 billion in outlays for the Department of Defense in FY 1987. The FY 1987 defense request is consistent with the goal of controlling federal spending as reflected in the agreement between the Congress and the President. In fact, the defense topline of $311.6 billion for FY 1987 is well below the $314.7 billion target specified in the budget resolution.

The size of the defense topline must be considered, of course, in the context of the total fiscal picture. However, we simply cannot use topline real growth rates as a yardstick for defense budgeting. In the final analysis, the Department of Defense does not have to spend a particular amount of real growth, but it does have to fund real programs to meet real risks.

The proper level of defense resources cannot hinge on snapshot calculations of real growth based on rapidly changing and arbitrary economic assumptions. The Congress must also look carefully at the programs being purchased. It must assess the priority of the defense program as an element of federal spending and the priorities of the programs within the defense budget. That is the way the Administration has developed the defense request and how the Department is ready to defend it. Unfortunately, there has been an increasing tendency by some in the Congress to refuse to address defense priorities and only want to deal with the defense topline.

Congressional Action on the FY 1986 DoD Budget:

Frankly, this approach makes a travesty of both the Administration's efforts to develop a budget that conforms to the latest available congressional direction, and the congressional efforts to review and adjust it to reflect its own priorities. Last year, for example, the Armed Services Committees spent many months enacting a bill that reduced the President's FY 1986 defense request by $19.2 billion. This was difficult work, but it did produce a defense program reflecting congressional priorities for a budget that size.

The problem is that the Congress subsequently decided that it didn't want a budget that size, but one $5 billion lower. That budget was enacted in the Continuing Resolution. Then came the Gramm-Rudman legislation and another $11 billion reduction, for a total reduction of $35 billion from the President's request. So, in the end, the Congress did not provide even the zero real growth in defense spending which it had endorsed only three months earlier, but instead a 6.2 percent decline.

America's defense posture requires a stronger commitment from the Congress than this; a commitment to return to a solid and consistent budget plan for national security resources. The Congress must decide whether we are going to budget for what we need in defense, as measured by the increasing risk we face, or

whether we are going to squander past gains and return to the practice of regarding defense spending as the balance wheel of fiscal policy -- a practice which gave us the hollow forces of the 1970's.

New investment programs represent only a little more than one-tenth of total defense spending planned for FY 1987. Therefore, imposed reductions will threaten readiness efforts, pay and end strengths, and existing prior year contracts.

Neither the Department of Defense nor anyone else can manage a rational or efficient modernization program when budget resources change unpredictably from year to year, much less so when they do so from month to month, long after the fiscal year they affect has commenced. Program managers and military leaders have nothing on which to plan when budget levels constantly shift under their feet.

The Administration is presenting a sound defense budget for FY 1987. It is consistent with the Congress' own budget plan of a few short months ago. It builds upon the results of the resources the Congress has previously provided for defense. It continues the initiatives of the past four years. Its objective is to complete and sustain the efforts and improvements already realized. I urge the Congress to get the defense debate back on track by considering the FY 1987 defense budget request in terms of the priorities upon which it was built, and the risks we face from ever growing Soviet military strength.

Confronting Soviet Capabilities:

Development of our defense program and budget begins with an assessment of the current and projected risks to U.S. national security. In this respect Soviet military capability remains the dominant consideration.

The Soviet modernization program, which started several years sooner than ours and at a faster pace, continues unabated. The Soviet Union is aggressively acquiring a military force

capable of accomplishing its stated goal of extending Soviet control and dominance throughout the world.

As a result, several military power balances long favorable to the United States have begun tilting in favor of the Soviet Union. Gorbachev's ascension to the post of General Secretary has brought about greater public posturing on issues vital to East-West relations in an effort to project a more positive image. And, while Soviet public relations may have undergone a cosmetic improvement, Soviet military growth continues with new strategic and conventional systems being fielded, and even more advanced systems under development or in various stages of research. The Soviet military, of course, will continue to receive strong support from the new leadership, and to enjoy its place of prominence in the allocation of resources.

Our security strategy is to build the strongest possible deterrence. We seek to protect our interests and those of our allies by preventing war. We seek to accomplish this by convincing potential adversaries that the costs of attacking us would far exceed any gain they could hope to achieve.

We do not, nor could we, seek to create a credible deterrence alone. In Europe, NATO continues to maintain a credible capability to deter a Warsaw Pact attack. In Asia, the military balance favors the Soviets, but with our current modernization programs the long-term trend favors us and our Asian allies and friends. The ability to project our power still favors us, but we must continue to monitor carefully Soviet programs enhancing their force projection capability.

NATO and Warsaw Pact Forces:

The Soviets have achieved an overall quantitative advantage in conventional weaponry. Further, the quality of their weaponry has improved significantly, often as the direct result of purchase or theft of western technology. Finally, the Warsaw Pact allies have created a military force that far exceeds one necessary to defend their territory.

Certainly there is not the slightest indication that a reduction in our commitment to invest in our military forces will result in a corresponding reduction by the Soviets and their allies or an abandonment of their strategic objectives. The evidence of the past is quite to the contrary. Indeed, if the United States were to devote the same percentage of its GNP to its military as the Soviets do, we would not be submitting an FY 1987 defense budget of $311.6 billion, but of some $700 billion.

FY 1987 Defense Program:

The United States must sustain the long-term program for rebuilding strength adequate for secure deterrence. If peace seems expensive, consider the alternative. By scrimping on strength, we can reduce our security and increase the risks of war. But if we fail to keep the peace, the cost to our standard of living, indeed to our lives and our country, would be incalculable.

The FY 1987 program is intended specifically to address the risks confronting the security of the United States within the fiscal constraints established by the Congress in the budget resolution last year.

The FY 1987 DoD budget reflects a reevaluation and revalidation of our basic force requirements. It is built upon the same force goals and continues the same modernization programs which the Congress has approved over the last four years. The only changes are further efforts to employ greater procurement economy and efficiency to achieve these goals in the most expeditious fashion.

Defense Manpower:

Active Duty Personnel

No turnaround these past five years has been more remarkable than the improvement in personnel quality and retention

throughout all components of the military Services. The FY 1987 budget requests $76.8 billion for military personnel costs.

Of this amount, $67 billion supports the active duty personnel. Active force end strength is programmed to increase by an additional 14,000 in FY 1987. The majority of this increase, 11,400, supports the Navy's active fleet, which goes from 553 ships in FY 1986 to 566 in FY 1987. The growth in end strength will provide manning for new ships and squadrons and other direct fleet support requirements.

An additional 1,500 increase in end strength is requested for the Marine Corps to support continuing Fleet Marine Force improvements, highlighted by the addition of a Target Acquisition Battery, conversion of aircraft squadrons to AV-8B, F-4, and F/A-18 aircraft, and the activation of a ship's detachment for the USS Wisconsin.

Recruiting and Retention

While we continue to maintain favorable recruiting and retention levels of high quality personnel, some figures this year in retention raise concerns about our future ability to compete successfully in an increasingly favorable economy.

To counter this reversal, the FY 1987 budget continues our support for adequate compensation and an adequate basic standard of living for all our servicemembers.

Although budget constraints have kept military pay raises at a modest levels during the last few years, the Administration remains committed to the principle of pay comparability and strives to maintain an overall military compensation program that can compete with other employment alternatives. Therefore, the current budget request proposes a 4 percent military pay raise effective October 1, 1986, which is comparable to anticipated private sector wage increases and prevents further

widening of the pay comparability gap, currently estimated to be 8.3 percent.

Retired Pay

The FY 1986 Department of Defense Authorization Bill directed the Department to submit legislation to achieve a $2.9 billion savings by changing the military retirement system for new personnel entering the Service. The FY 1986 Appropriations Bill deleted the $2.9 billion from our budget but provided authority to transfer up to $2.9 billion of prior year balances back into these accounts to cover the higher costs we will incur until the Congress enacts the retirement changes. However, the Appropriations Act provides only temporary relief to the Department since it requires that, after May 1, 1986, we must revert to the obligation limits imposed by the Authorization Act. Legislation to change the retirement system and to lift the obligation caps was submitted to and is currently being considered by the Congress. If retirement reforms or relief from the obligation caps are not enacted, the Services would have to reduce military personnel by over 330,000 active and 176,000 reserve spaces.

Reserve Components

The increasing role of the Reserves demonstrates the success of our Total Force Concept. As a percentage of total forces, the Reserves are making a significant contribution.

The budget includes $9.8 billion in support of the Reserve components and reflects an increase of 52,000 end strengths for the Reserve and National Guard components. This increase will allow the Army Reserve to reach the goal of 90 percent trained-in-unit strength in FY 1987 and support 105 unit activations and 70 deactivations.

The Reserves continue to receive our most modern equipment and weapon systems. These include M-1 tanks, Bradley Fighting

Vehicles, AH-64 Apache and UH-60 Blackhawk helicopters, KC-130T tanker and C-130H cargo aircraft, as well as F-16 fighters.

The role of the Naval Reserve Force (NRF) continues to increase. In FY 1987, the first of two reserve squadrons of airborne mine countermeasures helicopters will be established. Eventually, all of our new MCM 1 mine countermeasures ships will be operated by the NRF, as well as an increasing number of amphibious assault and support ships.

Civilian Personnel

The budget reflects an increase of 4,400 civilian end strengths to provide for a wide range of programs and activities. This increase reflects the emphasis being placed on our efforts to improve the acquisition of weapons through improved contract administration and audits. The FY 1987 budget requests a 3 percent pay raise for the civilian workforce, effective January 1, 1987.

Modernization:

Strategic Forces

The FY 1987 budget continues the President's commitment to modernize and improve all aspects of our strategic forces in order to ensure a stable deterrent and create a favorable atmosphere for arms reductions talks. Funds are requested to purchase 21 MX test missiles and for research on new basing modes. In keeping with recent congressional limitations, we plan to place only 50 MX missiles in existing Minuteman silos. We are also requesting funds to begin full-scale development of a new small ICBM.

An additional TRIDENT nuclear submarine is requested as well as the initial procurement of 21 TRIDENT II (D-5) missiles, the first U.S. sea launched ballistic missile capable of retaliating effectively against hardened Soviet targets.

Research and development funding is requested for the continued development of the Advanced Technology Bomber and two

new bomber-delivered weapons, for the advanced cruise missile, and for the short-range attack missile. No funds are requested for further procurement of B-1B bombers. That program has been completed below budget and ahead of schedule. The B-1 program remains as a model of how efficient defense acquisition programs can be if they are executed as planned.

Conventional Forces

In the area of conventional forces, we continue to place emphasis on maintaining modern forces that are properly equipped, adequately supported, and carefully balanced between active and reserve components and between the United States and allied capabilities.

Our inventories are making substantial gains as the Army maintains its force level of 18 active and 10 reserve divisions. The FY 1987 budget continues our investment in our land forces by requesting 840 M-1 tanks, 870 Bradley Fighting Vehicles, and 144 AH-64 Apache helicopters.

The FY 1987 budget supports the goal of a 600 ship navy by FY 1989, 15 carrier battlegroups and 4 battleship battlegroups. The budget reflects the procurement of 5 AEGIS ships; 2 CG-47 cruisers and 3 DDG-51 guided missile destroyers. Acceleration of the Navy's F/A-18 procurement, with procurement of 120 aircraft in FY 1987, demonstrates our commitment to achieve our inventory goals for this critical fighter/attacker.

The budget commits the necessary resources, beginning in FY 1987, to achieve the 40 tactical airwing goal, up from our current 37. This is reflected in the procurement of 48 F-15 and 216 F-16 fighter aircraft for the Air Force. FY 1987 marks the completion of procurement of 50 C-5B airlift aircraft.

Supporting the modern weapon systems being obtained by our forces are continuing procurements of strategic and tactical missiles. The Army is procuring 700 Patriot and 4,180 Stinger missiles in support of its ground forces. The Navy and the Air Force are procuring an additional 2,337 Sidewinder and 2,095 Sparrow missiles for their tactical forces. And, the Air Force continues procurement of Ground Launched Cruise Missiles (GLCM), with an additional 76 planned in FY 1987.

Emphasis continues to be placed on our Special Operations Forces (SOF). To ensure that we achieve the high state of readiness required for the Special Operations Forces to meet their key role of contingency response, the FY 1987 budget reflects a variety of modernization and expansion efforts.

Procurement of 5 modern transport and reconnaissance MC-130H airlift aircraft will provide modern avionics and electronic countermeasures capabilities, as well as an all-weather capability to transport troops in covert military operations. The budget also supports the development of materials for use by Army SOF aircraft in areas of Terrain Avoidance Radar, engine upgrades, and integrated cockpits.

Research, Development, Test & Evaluation:

Resources provided for research and development are of particular importance because they represent investment in future military capability.

As the President's highest priority effort, we are vigorously pursuing experiments and demonstrations to assess the feasibility of Strategic Defense Initiative technologies to support development decisions planned for the 1990s.

The LHX will replace the Army's aging inventory of lightweight combat, utility, and observation helicopters with a new technology, cost-effective rotorcraft. Further, we are actively exploring gun/missile combinations and new sensors to

provide our forward area troops with an effective short range air defense capability now that we have cancelled the DIVAD program.

In an effort to assure that we can meet the air-to-air combat threat of the 1990's and beyond, we are investigating the latest technologies in fighter avionics and engines.

We are at the peak period in the development and testing of the JVX tilt-rotor aircraft which will drastically cut the exposure time for Marines as they perform their vertical assault mission.

And, development is well underway for a faster, quieter, attack submarine and its advanced combat system to maintain our relative capability against the latest Soviet submarine class.

Readiness and Sustainability:

In addition to manning and modernizing the force, we have placed a high priority on continuing the marked improvements made over the last four years in the sustainability of our forces. Special emphasis has been placed on the acquisition of sonobuoys, due to the important role they play in the early detection of enemy submarines, and to increases in surface-to-surface missiles, such as Tomahawk and Harpoon.

The progress achieved in the inventory levels of our munitions is truly a success story. But, these are the very types of successes that will be the first to turn into shortages under successive Gramm-Rudman sequestrations, since there is no possibility, under the law, of choosing any priorities.

Training Improvements

Given the quantitative advantage of the Warsaw Pact nations in munitions and weapon systems, the Navy and Air Force have emphasized increased training, through higher levels of flying hours and steaming days for our airmen and sailors, in order to use our munitions more effectively and efficiently. The Army has increased the rotation of battalions through the National

Training Center. These efforts now, at last, compare favorably with the training provided our adversaries. And, in FY 1986, we will be conducting 86 exercises in cooperation with 45 countries.

As we have increased our training and operating tempos, we have increased the need for maintenance and logistic support. Increased unit, intermediate and depot-level maintenance requirements are provided for in the budget.

With this budget, we will be able to maintain the readiness and sustainability improvements made to date and make modest further improvements in the ability of our forces to accomplish mission objectives. But we will not be able to maintain these improvements in readiness and sustainability if this budget is cut by congressional action or Gramm-Rudman sequestration, or both, as happened this year.

DoD Management:

Good management is the third major priority upon which this defense budget is based. There is more accountability within the Department than ever before. We are controlling cost growth. The cost growth for 84 major weapons systems was 1 percent or less for the two recent years. Compared with an annual cost growth over 14 percent in 1980 and many prior years, this is a major achievement.

What product is the American taxpayer buying today for less than we paid in FY 1982? The B-1B bomber, F/A-18 fighter, and AH-64 helicopter to name but three major weapon systems that are being bought for less today than we were paying when this Administration entered office. The secret of this success can be summarized in two words: competition and management. Since 1980, the number of competitive contract actions has increased by 37 percent, so that today more than two-thirds of all contract actions have been awarded on the basis of competitive bids. Management that demands performance has reduced cost growth, increased quality, and kept programs on schedule.

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Repeated incomplete and erroneous reference to a few widely published items should not always be allowed to obscure the facts, and the facts are that the Department's management, with measurable results, is vastly improved. Additional details on these improvements are set forth below.

Auditing capabilities have been significantly improved and this request takes that further.

I hope the various outside studies now underway will take due note of the Department's successes in procurement in recent years, for the successes truly point the way to even better management in the future.

Acquisition Improvements

We have reduced the cost of our major weapons systems, delivered them on or ahead of schedule, improved the quality of those systems, and built up the industrial base to accelerate production should it be necessary in the future. These accomplishments were made, in large part, through wider use of competition, multiyear procurement, economic production rates and through stable procurement plans. The B-1B and M-1 programs are two notable successes in this regard; as well as our shipbuilding and aircraft programs and many others.

The total number of annual competitive contracts has increased by 37 percent to over 6 million contracts since FY 1980. In FY 1985 nearly 72 percent of all contract actions, amounting to $105 billion, were awarded under competitive contracting. Competition in shipbuilding has increased from 26 percent in FY 1981 to approximately 90 percent at the end of FY 1985. Currently, there are 44 major Department of Defense systems and subsystems that are dual sourced. Many of the remaining sole source programs are essentially follow-on contracts, awarded to the winning bidder after competition.

Savings from multiyear procurement and economic production rates are projected to be over $11.0 billion since 1982. While the dollar savings from these programs are substantial, an

equally important benefit is the improvement in quality of weapons and the increase in the industrial base. These benefits flow from a stable work force, dual sourcing, and competition among subvendors associated with economic order quantity procurements and economic production rates.

Improving the Department's procurement and acquisition process has been a particular priority of mine. Additional people have been added to staff increased Department of Defense competitive procurement and to improve price surveillance. These efforts have reduced prices across the board. Under this program we have reviewed 250,000 items and designated 54,000 items for full and open competition. We identified another 51,000 items for purchase from the manufacturers, thereby eliminating "middle man" charges. We have documented spare parts savings in excess of $2.5 billion in FY 1984 and FY 1985. These initiatives have helped reduce the trend in spare parts spending by $11.1 billion from our projections in FY 1984.

We are pursuing management improvements whenever and wherever we can. And, while there is much that can be accomplished solely within the Department, we have made it clear to the defense industry that they, too, must be part of the solution.

The private sector has responded well. Some of our major suppliers have established their own spare parts awareness programs to get ideas from their employees on ways to keep costs down and improve quality. Contractors are voluntarily identifying items for competition or direct purchase from the actual manufacturers. And, many of our larger manufacturers are offering the best no-fault refund policy there is. It is simply this: if the Department thinks an item has been overpriced, the item can be returned for full refund.

Efforts to Stop Waste, Fraud, and Abuse

Still, we do not and cannot rely entirely on the goodwill of industry to prevent abuses. We have suspended or debarred more

than 1,400 defense contractors since 1981. Where there has been serious fraud or illegal activity, we have sought criminal indictments from the Department of Justice not only against the companies involved, but also against individual employees and officials who abused their trust.

Further, under this Administration, we have initiated the most comprehensive set of audits and investigations in the history of DoD. To monitor and control prices, we are continuing our aggressive audit efforts. During FY 1985, the Inspector General issued 125 audit reports that identified $1.1 billion in potential monetary benefits. Potential monetary benefits from all other DoD audits and reviews, including Service audit agencies and internal reviews, increased the total to $2.7 billion.

Department of Defense worldwide contract audit activities are conducted by the Defense Contract Audit Agency (DCAA). DCAA audit services result in over 60,000 audit reports annually. These audits have produced an estimated savings of $8 billion in FY 1985. Recently acquired subpoena authority, combined with a variety of new audit products and increased resources, should strengthen this already valuable arm of the Defense Department.

Management Improvements

The Department has also successfully implemented a broad range of initiatives in cash management, debt collection, administrative systems, and management reviews. Cash management initiatives have accounted for $225 million in savings through FY 1985, and an additional $160.5 million are projected for FY 1986. We have documented nearly an 80 percent improvement in Department of Defense management controls, as measured by the Federal Financial Management Integrity Act. In another area of congressional interest, we have reduced computer leasing costs by implementing more cost-efficient purchases of ADP equipment.

We have not limited our efforts for management improvement and associated savings solely to this Department and its

contractors. Since we and our NATO allies field the same weapon systems in the European theater, it makes sense to cooperate on the logistics support programs for those systems. We have joined weapon system partnerships with NATO allies for the Patriot missile and the Multiple Launch Rocket System and are actively pursuing similar arrangements for TOW and Lance. We are also working toward consolidated procurement of common NATO munitions.

Many of our allies have indicated support for SDI research and, in some cases, interest in participating. The United States and the United Kingdom recently signed a memorandum establishing the framework for British participation in the SDI program. Discussions are also being conducted with other NATO nations.

We have pursued every avenue to realize savings and efficiencies within the Department. We will continue to scrutinize defense operations, not just to see where waste and fraud is occurring, but to identify where it might occur. Such intense review should continue to be productive.

At the same time, there is a very counterproductive aspect in the current trend in congressional scrutiny of Department of Defense management. It is alarming to see an issue as important as the proper level of American defense preparedness hanging on questions such as whether departmental practices have resulted in over payment for a hammer or an airplane toilet seat as if a system of zero errors were the goal -- and particularly when the facts on those and other individual purchases are so distorted. It is discouraging to see some members of the Congress scrambling to publicize such instances, which have frequently been identified and corrected by the Department's own audit systems, as if they were participating in a fraternity scavenger hunt.

Such activities add little to the efforts that both the Congress and the Department already have underway and frequently

detract from the important issues confronting our defense planning. They are used most frequently to distort the true picture of the defense acquisition process. As is the case in all large operations our procurement system is subject to isolated abuses and mistakes. But the important fact is that these problems are being constantly ferreted-out and addressed while the larger process continues to perform well.

We sign 52,000 contracts every single day - of course there will be mistakes. The real question is, is anything being done to predict and correct mistakes, and any objective look would conclude we have made great improvements and are continuing to do so. Objective examinations are very useful but uninformed, distorted, and continual criticism, designed primarily to cover the level of severity, can have a detrimental effect on the morale of the very skilled and experienced people, civilian and military, who manage defense procurement. These dedicated people, upon whom we rely to produce our defense capabilities, should not be used as punching bags by those who profess themselves as being "strong on defense."

The fact is that, by and large, the defense acquisition system is working. Over the past five years our forces have acquired more and better weapon systems and equipment than most people, in 1981, believed was possible within the budgets we originally sought, which were larger than defense actually received; and we are doing it without the cost growth and overruns which formerly plagued the Department.

The 1987 budget proposes to buy more program for less money than most observers would have believed possible just last year. This is largely because of our focus on stable programs and because of the acquisition reforms we have made that are working. We are seeing now the results of greater efficiency. The introduction of additional reforms where they are needed has the highest priority within the Pentagon and is a topic of constant attention.

Gramm-Rudman:

A few words are in order regarding the implications of the Gramm-Rudman law for the defense program of the United States. In Gramm-Rudman a unique step has been taken. The Congress has said that it wanted to create a club with which to beat down the deficit because your existing processes had not achieved the desired result. But a club is a very indiscriminate weapon and, unless the Congress is careful, the chief collateral effect of Gramm-Rudman may be to undermine the U.S. defense infrastructure in ways that encourage Soviet risk taking, discourage their willingness to negotiate lower levels of arms, and thus increase the dangers of war.

The additional five percent defense reduction imposed by Gramm-Rudman this year after congressional enactment of the FY 1986 budget, reduced funding for all appropriations, except Research, Development, Test and Evaluation, to levels below those in FY 1985. People who criticize reductions that affect readiness will be right, but they should know that the statute gives us no option. Readiness, of course, will be affected first as training, spare parts, ammunition, and other important support items absorb these required reductions. Procurement efficiencies will also be impacted as a result of the Gramm-Rudman effect of underfunding the FY 1986 program by five percent.

Our allies and adversaries alike will recognize that domestic fiscal pressures, more than national security requirements, are determining our budgets for national defense.

But if the Congress simply enacts the President's budget or produces a budget consistent with the President's request, it can avoid triggering a sequestering process that could literally reverse the results of the past five years, and throw defense planning into chaos. I cannot exaggerate the impact if failure to enact the President's budget triggers Gramm-Rudman.

Gramm-Rudman need not be triggered. The President has submitted a budget plan consistent with the FY 1987 deficit target. If this budget plan is not followed, however, and Gramm-Rudman is triggered in some of its more extreme scenarios, or if the Congress underfunds defense to avoid triggering, it could be the equivalent of unilateral disarmament. Moscow and our allies, who are regularly urged to spend more on defense, wait and watch with interest.

Conclusion:

I urge the Congress to get the defense debate back to the question of what this Nation's security requires. We have dwelt on terms like "real growth" and "toplines" too long and we risk losing sight of the reasons why we require a strong defense.

The Administration has made its priority choices regarding defense. The program before you is a good one. This defense budget is $3 billion below the budget specified by the Congress just a few months ago and agreed to by the President. I have yet to hear either a convincing explanation, or indeed any explanation, of why a funding level deemed necessary and affordable for national security a short time ago is now unacceptable. Surely no one contends the world has become more peaceful.

The Congress must make up its mind on this issue. No defense program, at any funding level, can function properly or efficiently, or deliver the safety required for the Nation, without consistency and sustainability and some concern for the realities of the world.

Military planners and program managers cannot be haunted annually by the spectre of a defense budget freeze or 6 percent reductions and remain effective. Neither the benefits of efficient contracting nor the required security of the Nation can be realized if we thus ignore our real needs.

The world is watching to see what the Congress determines this year. We should work together to inspire public confidence

and respect for a defense program that ensures our national security. The effort to provide increased military readiness and force modernization which has yielded so much in the past five years should be sustained. The Congress as a whole should not be a party to the distortion and exaggeration about the defense program practiced by those who seemingly would prefer to see these results reversed.

In peacetime the defense budget is perhaps the single most significant statement of the United States' defense policy and objectives. We should send a strong message to friends and adversaries alike that the security of the United States is not a whim of economic statistics, but a bedrock requirement and commitment which this Nation can easily afford.

CHART 1

DOD TOPLINE REDUCTIONS

(BUDGET AUTHORITY in BILLIONS)

	1982	1983	1984	1985	1986	TOTAL 1982-1986
Amendment March, 1981	221.8	254.5	288.9	326.2	367.2	1,458.6
INCREMENTAL ADJUSTMENTS TO PLAN						
Sept 1981 through FY 1985 Enacted	-8.0	-15.0	-30.7	-39.4	-42.4	-135.5
FY 1986 Budget - Jan 1985	-	-	-	-	-11.1	-11.1
FY 1987 Budget - Jan 1986	-	-	-	-	-24.2	-24.2
PL 99-177	-	-	-	-	-11.0	-11.0
TOTAL ADJUSTMENTS since MARCH, 1981	**-8.0**	**-15.0**	**-30.7**	**-39.4**	**-88.8**	**-181.9**
Current TOPLINE	213.8	239.5	258.2	286.8	278.4	1,276.7
OUTLAY ADJUSTMENTS since MARCH, 1981	**-1.9**	**-16.1**	**-29.0**	**-51.9**	**-77.6**	**-176.5**

DOD CONTRIBUTIONS TO DEFICIT REDUCTION EFFORTS

($ BILLIONS)

	FY 1984	FY 1985	FY 1986
FEDERAL DEFICIT			
January 1984 Estimate	183.7	180.4	177.1
Actual	185.3	212.3	202.8 (e)
Difference	+1.6	+31.9	+25.7 (e)
DOD OUTLAYS			
January 1984 Estimate	231.0	264.4	301.8
Actual	220.8	245.4	258.4 (e)
Difference	-10.2	-19.0	-43.4 (e)

e = Estimated in President's FY 1987 Budget.

CHART 2

FY 1987 DEPARTMENT OF DEFENSE BUDGET
BUDGET AUTHORITY & OUTLAYS
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
BUDGET AUTHORITY	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**
OUTLAYS	245.4	263.6	278.0
PL 99-177	-	-5.1	-3.8
NET OUTLAYS	**245.4**	**258.4**	**274.3**

CONGRESSIONAL ACTIONS
on FY 1986 DoD BUDGET
(CURRENT $ BILLIONS)

	BUDGET AUTHORITY LEVEL	REDUCTION
President's Budget Request	313.7	
(0- 3-3 % growth compromise)	[294.5]	(-19.2)
Authorization Bill	294.5	-19.2
Continuing Appropriations	289.5	-5.0
SUB TOTAL		**-24.2**
PL 99-177	278.4	-11.0
TOTAL BUDGET AUTHORITY REDUCTION		**-35.2**
TOTAL OUTLAY REDUCTION		**-19.1**

FY 1987 DoD B/A & OUTLAYS

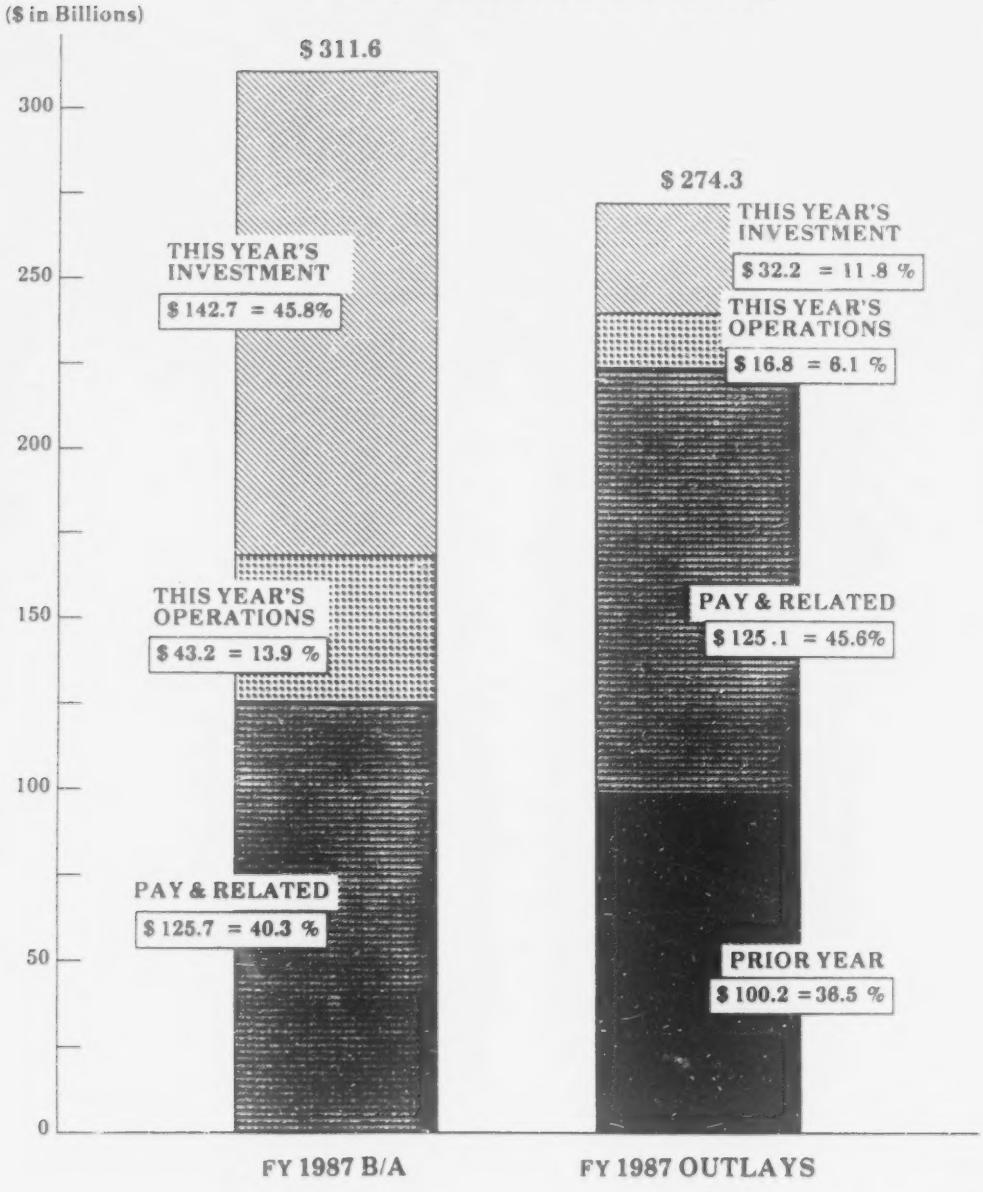


CHART 3

PRODUCTION OF SELECTED WEAPONS for NATO and WARSAW PACT FORCES

(1975 - 1987)

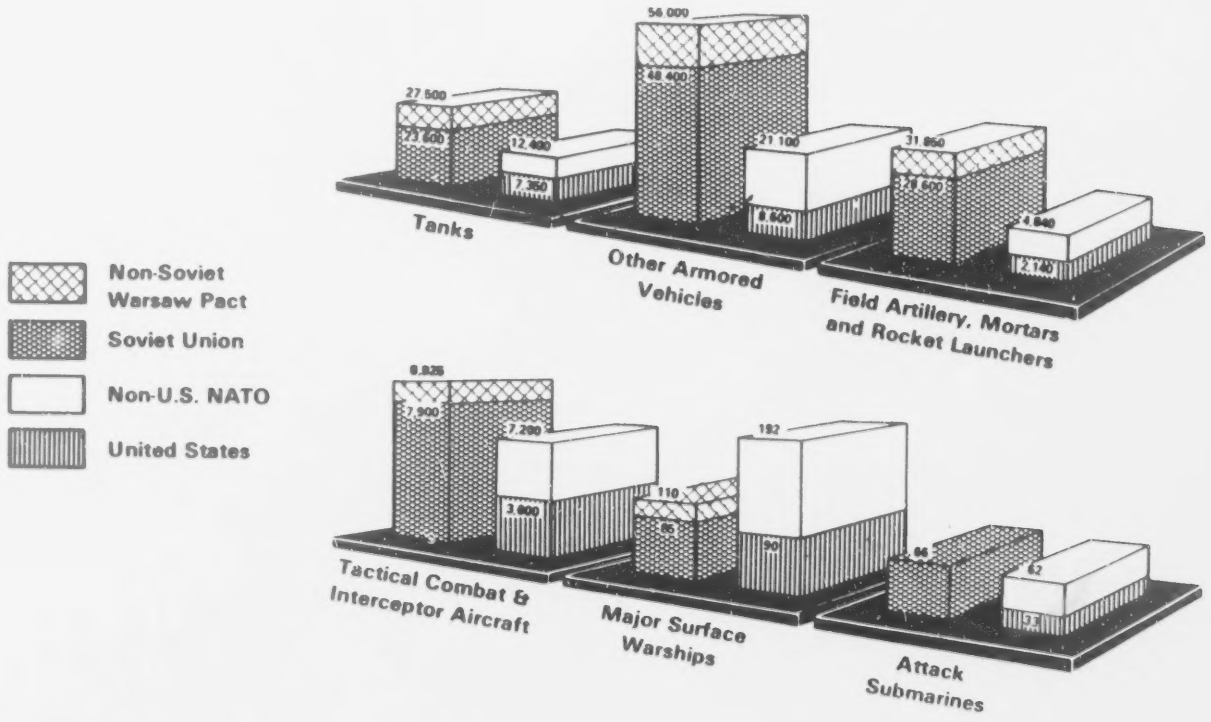
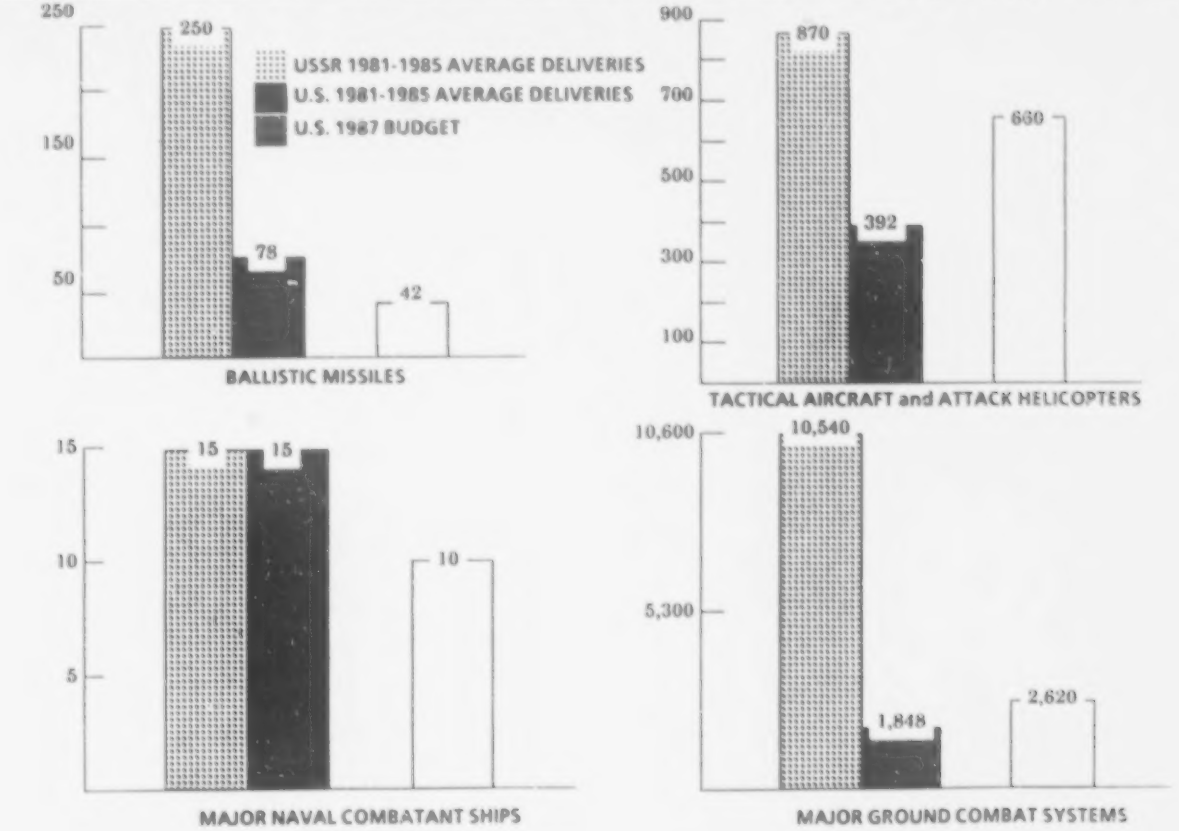


CHART 4

COMPARISON of 1981-1985 EQUIPMENT DELIVERED with FY 1987 BUDGET



FY 1987 DOD BUDGET
BUDGET AUTHORITY BY TITLE
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
MILITARY PERSONNEL	67.8	67.9	76.8
O&M	77.8	78.7	86.4
PROCUREMENT	96.8	97.3	95.8
RDT&E	31.3	35.5	42.0
MILITARY CONSTRUCTION	5.5	5.6	6.8
FAMILY HOUSING	2.9	2.9	3.4
OTHER	4.7	1.6	0.5
TOTAL	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY TITLE
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1986 G-R-H	FY 1987
MILITARY PERSONNEL	67.8	67.9	-0.2	76.8
O&M	77.8	78.7	-3.8	86.4
PROCUREMENT	96.8	97.3	-4.7	95.8
RDT&E	31.3	35.5	-1.7	42.0
MILITARY CONSTRUCTION	5.5	5.6	-0.3	6.8
FAMILY HOUSING	2.9	2.9	-0.1	3.4
OTHER	4.7	1.6	-0.1	0.5
TOTAL	286.8	289.4	-11.0	311.6

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY MILITARY FUNCTION
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1987
ARMY	74.3	74.9	81.5
NAVY/ MARINE CORPS	99.0	98.5	104.5
AIR FORCE	99.4	98.3	105.2
DEFENSE AGENCIES	13.1	15.9	19.5
DEFENSE WIDE	1.0	1.9	0.9
TOTAL	286.8	289.4	311.6
PL 99-177	-	-11.0	-
NET B A	**286.8**	**278.4**	**311.6**

FY 1987 DOD BUDGET
BUDGET AUTHORITY BY MILITARY FUNCTION
(CURRENT $ BILLIONS)

	FY 1985	FY 1986	FY 1986 G-R-H	FY 1987
ARMY	74.3	74.9	-2.5	81.5
NAVY/ MARINE CORPS	99.0	98.5	-3.7	104.5
AIR FORCE	99.4	98.3	-3.9	105.2
DEFENSE AGENCIES	13.1	15.9	-0.8	19.5
DEFENSE WIDE	1.0	1.9	*	0.9
TOTAL	286.8	289.4	-11.0	311.6

* Less than 0.1

CHART 5

FY 1987 DEPARTMENT OF DEFENSE BUDGET

MANPOWER

(IN THOUSANDS)

	FY 1985	FY 1986	FY1987	Change FY 86-87
MILITARY ACTIVE DUTY				
ARMY	781	781	781	-
NAVY	571	581	593	+ 12
MARINE CORPS	198	199	200	+ 1
AIR FORCE	602	606	607	+ 1
TOTAL MILITARY [1]	2,151	2,167	2,181	+ 14
RESERVE MANPOWER				
SELECTED RESERVES	1,088	1,134	1,186	+ 52
CIVILIAN MANPOWER				
TOTAL CIVILIAN [2]	1,129	1,110	1,114	+ 4

Note: 1. Includes Military assigned to Defense Agencies and Cadets.

2. Civilian End Strength includes Classified, Wage Board, Foreign Indirect, Civilian Technicians, and Permanent Part-time.

CHART 6

PERCENT OF RECRUITS WITH HIGH SCHOOL DIPLOMAS

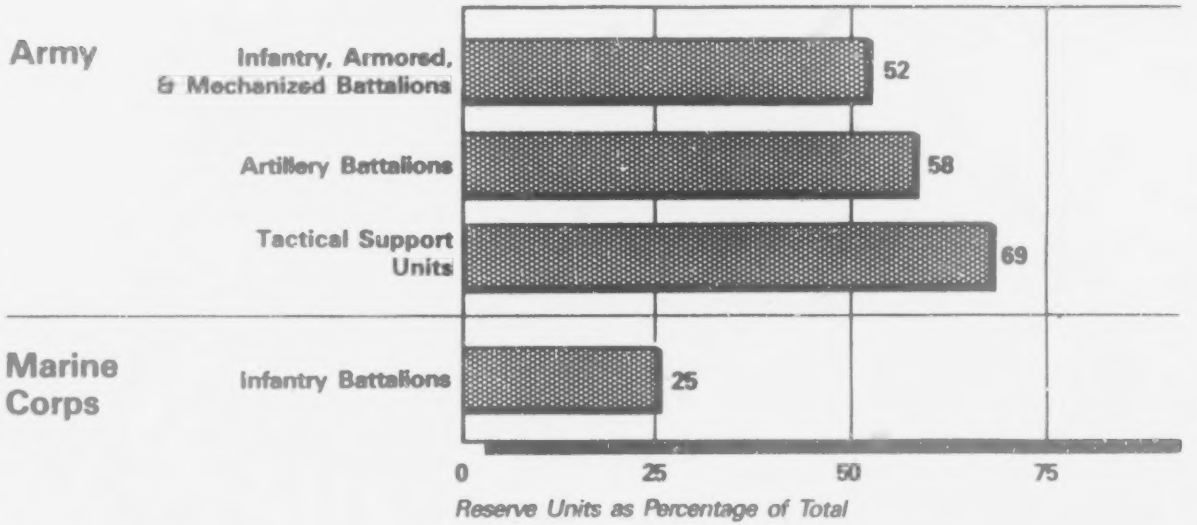
Service	1980	1981	1982	1983	1984	1985
Army	54	80	86	88	91	91
Navy	75	76	79	91	93	89
Marine Corps	78	80	85	92	95	97
Air Force	83	88	94	98	99	99
Total	**68**	**81**	**86**	**91**	**93**	**93**

PERCENT OF FIRST TERM REENLISTMENTS

Army	50.6	55.0	58.6	45.3	43.8	43.1
Navy	36.7	41.7	50.3	55.7	58.0	54.5
Marine Corps	23.2	26.6	34.0	33.3	39.5	35.4
Air Force	35.8	42.9	56.9	65.8	61.9	53.9
Total	**39.1**	**43.0**	**52.9**	**51.6**	**51.2**	**47.8**

CHART 7

PROJECTED CONTRIBUTION of RESERVE COMPONENTS
(END OF FY 1987)



ANNUAL CHANGE IN GUARD AND RESERVE FUNDING
(Less Congressional Adds - $ in Millions)

FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987
+420	+1,534	+2,177	+3,594	+1,860	+740

CHART 8

Major Equipment Procured for Guard/Reserve

	FY 1985	FY 1986	FY 1987
Army			
AH-64 Attack Helicopters	18	18	-
UH-60 Blackhawk Helicopters	2	15	32
Bradley Fighting Vehicles	174	32	-
M-1 Abrams Tanks	180	60	120
High Mobility Multipurpose Wheeled Vehicles (HMMWV)	1,572	5,872	2,476
Navy			
UH-60 Blackhawk Helicopters	2	4	-
KC-130T Tanker Aircraft	2	2	-
MK-15 Close In Weapon System (PHALANX)	4	6	1
M-198 Towed Howitzers	-	50	36
High Mobility Multipurpose Wheeled Vehicles (HMMWV)	643	1,719	-
Air Force			
C-130H Aircraft	16	16	-
F-16 Aircraft	30	-	-
Fuel Tank Trucks	50	45	57
Flightline Tow Tractors	115	41	77
Fire/Crash Trucks	84	69	102

CHART 9

ARMY MODERNIZATION

	On Hand FY 1980	On Hand FY 1985	FY 1986 & Prior Auth/Approp & soon to be delivered	FY 1987
Close Combat				
M-1 Tanks	34	3,021	1,956	840
Bradley Fighting Vehicles	-	1,936	1,735	870
Helicopters				
AH-64 Apache	-	45	408	144
UH-60 Blackhawk	-	684	93	78
Air Defense Missiles				
Patriot	-	612	1,563	700
Stinger	-	6,554	8,005	4,180
Artillery				
M L R S	-	204	144	44

CHART 10

NAVY/MARINE CORPS MODERNIZATION

	On Hand FY 1980	On Hand FY 1985	FY 1986 & Prior Auth/Approp & soon to be delivered	FY 1987
Tactical Aircraft				
F-14A	322	430	54	15
F/A-18	-	234	252	120
AV-8B	-	32	105	42
P-3C	176	229	21	9
Ships				
SSN-688 Submarine	10	28	24	4
AEGIS Ships	-	3	17	5
Frigates	71	112	5	-
Battleship Reactivation	-	2	2	-
Trident Submarine	-	6	7	1
Strategic Missiles				
TRIDENT I	144	518	52	-
TRIDENT II	-	-	-	21
Tactical Missiles				
Sidewinder	4,510	5,899	1,823	627
Sparrow	2,236	2,753	2,932	1,716

CHART 11

AIR FORCE MODERNIZATION

	On Hand FY 1980	On Hand FY 1985	FY 1986 & Prior Auth/Approp & soon to be delivered	FY 1987
Tactical Fighters				
F-15	507	728	105	48
F-16	157	838	398	216
Strategic Aircraft				
B-1B	-	2	100	-
Mobility Aircraft				
KC-10	-	35	57	8
C-5B	-	-	29	21
Strategic Missiles				
PEACEKEEPER	-	-	54	21
ALCM-B	12	1,472	267	-
Nuclear/Tactical Missiles				
GLCM	-	196	288	76
Sparrow	8,192	10,302	1,965	379
Sidewinder	11,617	16,753	3,581	1,710

CHART 12

SPECIAL OPERATIONS EXPANSION

	FY 1981	FY 1987
Total Funding ($ millions)	$441	$1,693
MC-130 Aircraft	0	5
Special Forces Groups (includes four Reserve Components)	7	8
Ranger Battalions	2	3
Psychological Operations Battalions	3	4
SEAL Teams	2	5 1/
SEAL Delivery Vehicle (SDV) Teams	0	2 1/
Seafox (Special Warfare Craft, Light)	8	36

1/ Includes two Underwater Demolitions Teams redesignated in 1983.

CHART 13

MAJOR FY1987 RDT&E PROGRAMS

($ in Millions)

	FY 1986	FY 1987
Strategic Defense Initiative	2,746	4,785
LHX Helicopter & Engine	114	155
DIVAD Alternatives	31	104
V-22 (JVX) Tilt Rotor Aircraft	555	387
SSN-21 Attack Submarine/SUBACS	576	670
Advanced Tactical Fighter	165	294
Small ICBM (Incl. Basing)	746	1,396
PEACEKEEPER (Incl. Basing)	696	721

CHART 14

IMPROVEMENTS IN MUNITIONS SUSTAINABILITY
(PERCENT INCREASE OVER FY 1981 POSTURE)

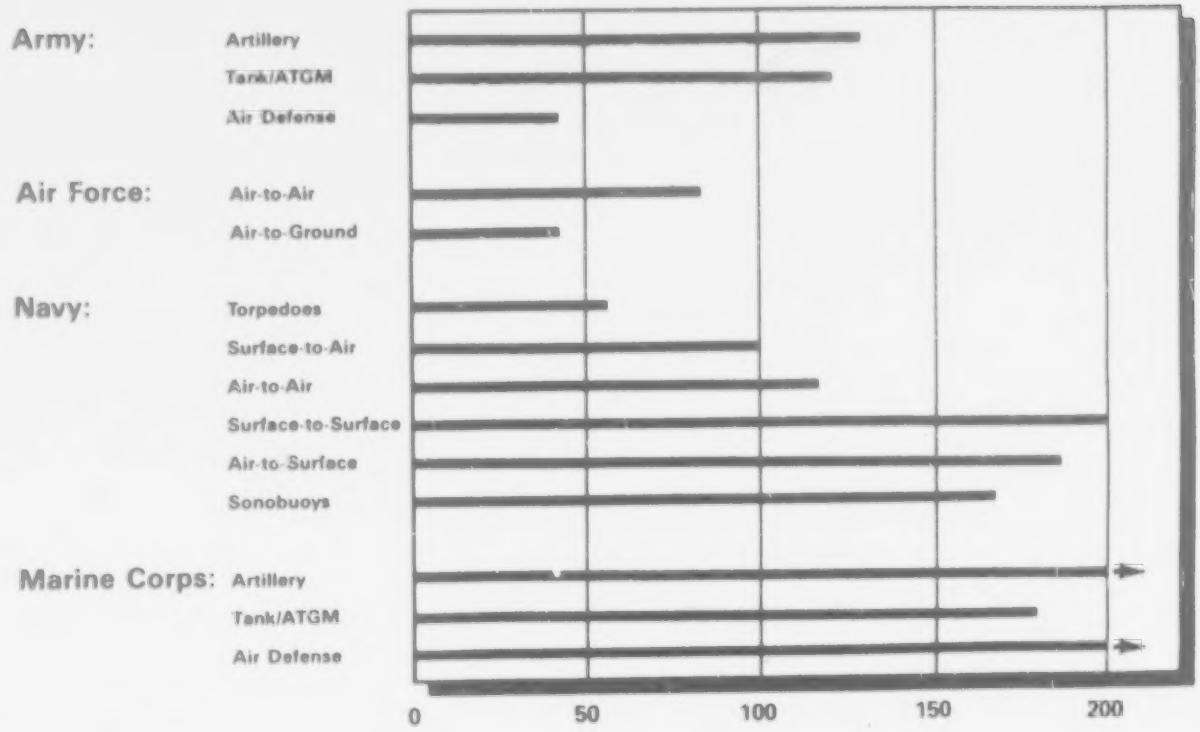
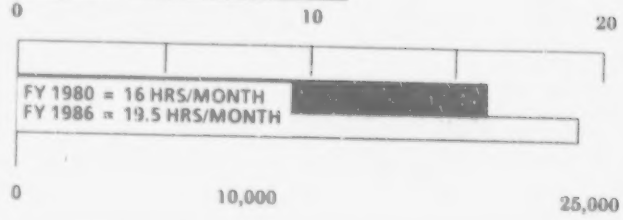


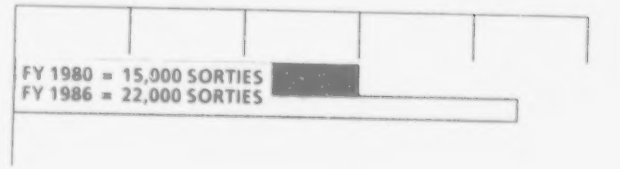
CHART 15

TRAINING IMPROVEMENTS

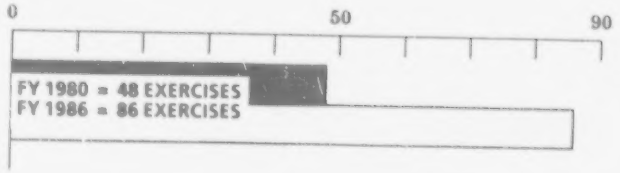
Air Force Tactical Aircrews:
19.5 flying hours/month



Air Force Tactical Aircrews:
22,000 Red Flag exercise sorties



Increased JCS Exercises:
86 Exercises



Army Battalions:
28 battalions/year rotating through National Training Center

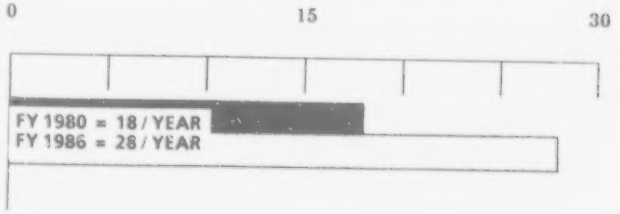


CHART 16

ACQUISITION IMPROVEMENTS

- **Cost Growth for Major Weapon Systems:**
  - end of CY 1980 — 14%
  - end of CY 1983/CY 1984 — 1%
- **Multiyear Procurements:**
  - FY 1982 - FY 1986:
    - 40 multiyear contracts approved/$6.2 billion in projected savings
  - FY 1987 budget :
    - 7 multiyear programs requested/$2.1 billion in anticipated savings
- **Increased Use of Competitive Contracts:**
  - 72% of all FY 1985 contracts competitively awarded (40% in FY 1981)
- **Spare Parts Acquisition Initiatives:** Savings of $2.5 billion
- **Economic Production Rates:** Savings of $2.7 billion

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MANAGEMENT IMPROVEMENTS

FINANCIAL MANAGEMENT:

- **Saved $225 million through improved cash management and disbursement procedures.**
- **Reduced the DoD's interest payment by $600,000.**

INTERNAL MANAGEMENT CONTROL:

- **Documented a 78% improvement in internal management controls.**

ADP:

- **Reduced uneconomical leases of ADP equipment by $905 million through cost-efficient purchasing.**

CHART 17

DOD EFFORTS TO CURB WASTE, FRAUD and ABUSE - FY 1985

CONTRACT AUDITS:

- **ESTIMATED SAVINGS** — **$8.1 billion**

INTERNAL AUDIT of DOD ACTIVITIES:

- **ESTIMATED SAVINGS** — **$2.7 billion**

INVESTIGATIVE ACTIVITIES:

- **RECOVERIES, RESTITUTIONS, and FINES/PENALTIES** — **$125.9 million**

FY 1987 DEPARTMENT OF DEFENSE BUDGET
LONG RANGE FORECAST
($ Billions)

	FY1987	FY1988	FY1989	FY1990	FY1991
BUDGET AUTHORITY					
CURRENT DOLLARS	311.6	332.4	353.5	374.7	395.5
OUTLAYS					
CURRENT DOLLARS	278.0	293.2	314.7	336.0	356.6
PL 99-177	-3.8	-2.5	-1.4	-0.5	-
NET OUTLAYS	274.3	290.7	313.3	335.5	356.6

The CHAIRMAN. Admiral Crowe.

STATEMENT OF ADM. WILLIAM J. CROWE, JR., USN, CHAIRMAN OF THE JOINT CHIEFS OF STAFF

Admiral CROWE. Mr. Chairman, with your permission I will summarize my statement which you have very kindly accepted for the record.

I welcome this opportunity to appear before the committee and to provide my assessment of the Nation's Defense Establishment.

This is my first participation in the budget process, at least at this close range.

I am convinced that the current posture of the Armed Forces is sound, and I can tell you that from personal observation of our forces in the field that your investment in national defense over the last few years has paid huge dividends. I have seen it over the last 5 years in major commands in both NATO and the Pacific and in my travels just in the few months that I have been the Chairman.

At the same time, I believe there is a great deal yet to be done to ensure the Republic's future security. First, it is imperative to understand that our military posture provides us a great deal more than just a shield against direct attack.

That same power underwrites our ability to use the sealanes both in peace and war, to communicate with friends overseas, to approach arms control negotiations with confidence, and to cement alliances which, in turn, enhance our own security. In fact, our strength has been an indispensable pillar not only of our own freedom but that of our allies, as well.

Before returning to Washington, I witnessed this first hand as I served in command billets that brought me in touch with most of our major allies and a good share of the Third World. In NATO, I observed that our military contribution to that coalition literally anchors its unity and political structure.

In the Pacific, a succession of Asian leaders emphasized to me the importance of a powerful America with forces forward deployed in the Far East. Last month I visited both Central America and the Middle East and found officials in those areas wanting a strong United States as a backdrop for their efforts to build free and functioning societies.

In essence, our military capability provides us a host of benefits every day, a return on our investment, so to speak, in terms of both national security and foreign policy. At the same time, I believe it is important to recognize that our strategy is determined not only by our own interests but also by the actions of our opponents.

Over the last 30 years, every one of my predecessors has expressed concern about the Soviet worldwide threat and at the evolving military balance. Today, the size of the Soviet forces and the scale and momentum of the Kremlin's buildup or modernization efforts are still of significant concern.

I won't dwell on statistics and the adverse ratios we face, because Russian accomplishments are well documented, and I am sure this

committee is familiar with them, and Secretary Weinberger has touched on them in his remarks.

In summary, this buildup is unprecedented in world history and on sheer momentum will carry well into the 1990's, if not longer. In this regard, I believe it is important to note a few realities.

Soviet military doctrine consistently stresses the offense and a war-winning philosophy. The Kremlin is today capable of waging war on two fronts, east and west. The U.S.S.R. now has a global military reach, and that is indisputable.

Soviet arms customers are emerging as the military powerhouses, as well as the troublemakers of Southeast Asia, the Middle East, Africa, Caribbean, and Latin America.

Perhaps most disturbing, the qualitative edge the West has long enjoyed—and counted on militarily is being steadily eroded.

All things considered, I am persuaded that the United States will be in a far better position to influence the Gorbachev regime if we continue the discussions and negotiations from a position of increasing rather than sagging military strength.

But whatever you decide, let it be based on a full and unemotional appreciation of the peril we face. These threats cannot be assumed away, nor is it necessary to overstate them. They are impressive and ominous in their own right.

Let me move to the state of our Armed Forces now. Last year, General Vessey testified before this committee that by every commonsense measure, our forces are more ready than at any time in the recent past.

That statement remains valid today. Manpower, of course, is the heart of our force structure. I certainly would not want to see reversed the remarkable improvements that we have made in the manpower situation over the last few years.

Overall, personnel readiness is at the highest level of any peacetime period in our history. About 50 percent of the force are careerists, and as a result we have a solid cadre of midgrade officers and enlisted personnel who furnish the leadership that we so desperately need.

As an aside, Mr. Chairman, I might say that perhaps the greatest reward of a career in the military is the opportunity to work with and associate with young American men and women every day, and certainly those that we have in the service today give me a lot of encouragement. I am not worried about the future of the next generation.

I am also pleased to report that fiscal year 1985 was another successful year as measured by the quality of our recruits and overall retention rates. However, we do see potential warning signs in our enlisted retention, and in our ability to retain nuclear trained officers and experienced pilots.

None of this is perhaps cause for alarm at this time, but it serves to remind us that personnel readiness is a fragile thing, particularly when we are facing a shrinking pool of manpower. Consequently, a healthy personnel structure is always the first priority of the Joint Chiefs of Staff.

Let me turn to force modernization. The United States has no choice but to maintain a credible nuclear deterrent for itself and for those nonnuclear allies who depend upon it.

Unfortunately, U.S. strategic modernization lagged far behind Soviet efforts in the 1970's. As a result, we have been forced to refurbish all three legs of the triad at the same time, notably with the Peacekeeper missile, B–1 bomber, and Trident submarine.

Our current plans call for placing 50 Peacekeepers in the modified Minuteman silos. But in addition, as part of the modernization program, we urgently need to continue research in more survivable modes for basing the second 50 missiles, development of a smaller ICBM mobile launcher, and the advanced technology bomber.

In order to guard against tactical and technical surprises, it is essential to carry out the President's strategic modernization program which will, in turn, close the gap for many years to come.

I have just returned from Europe and was able to witness firsthand some of the new conventional equipment which is coming into the inventory as a result of investments made over the last 6 years.

Incidentally, while I was there I drove an M–1 tank. That was my first experience in a tank, but it is a lot like a submarine, I discovered.

But more importantly I had an opportunity to talk to the people who operate that equipment, both on the ground and in the air force that is based there, and to hear their ecstatic reports about the new equipment coming into the order of battle.

Similarly, during my tour in the Pacific we received a stream of modern weapon systems. All of this is most impressive, and is benefiting Active, Reserve and National Guard Forces alike. It is not just quantity we are adding, but quality as well.

It is also important, however, to stress that there is still much to do. To cite 1985 figures from the Active Forces, only one-third of our tank battalions have the new M–1; one-fourth of our mechanized battalions have the Bradley fighting vehicle; only one-fifth of the air defense SAM missile batteries are equipped with the new Patriot; two-thirds of the Air Force tactical fighter squadrons have been modernized with the new F–15's, F–16's, and A–10's. One-third of the Navy submarine force is operating the new 688 class. Slightly over one-third of the Navy's battle group have the new Aegis-equipped ships. More progress will be seen over the next 2 years as equipment currently in the pipeline comes into the inventory. But it should be clearly understood that we are still in midstream in our modernization efforts.

To falter now would stretch out the entire process, leave many of our units behind the power curve in quality, frankly, prove more expensive in the end, and once again hand the Soviets the opportunity to widen the gap militarily.

The fiscal year 1987 budget recognizes this reality and continues the momentum. New acquisitions have been complemented by a rigorous training program designed to capitalize on the enhanced capabilities coming into our forces. Our exercises are bringing together all the services and increasingly include National Guard and Reserve units. Likewise, we stress more and more the logistics side of war fighting.

The Reforger exercise in Western Europe, Team Spirit in Korea, and CENTCOM is Bright Star in the Middle East are annually enhancing our ability to project power to those areas where we have

strong interests. These three are just the tip of an exercise iceberg which is steadily becoming more joint, realistic, and innovative. Our training today is stimulating and exciting , and if you visit the people in the field, they will tell you that.

Other improvements can be seen in the sustainability or combat staying power of our forces. Over the last 6 years, we have seen substantial growth in U.S. expenditures for sustainability. Some of the charts which Secretary Weinberger showed you illustrate this.

The funding for ammunition and spare parts has grown by over 25 percent, and ammunition inventories of all services have improved substantially. That is a concern that all of our operational commanders have.

In Europe, for instance, ground ammunition tonnage is up 18 percent. I saw it there this month. It has almost doubled in the Pacific. Our people are getting new confidence. They have always believed that they were capable, that they were going to have good equipment, and that they would be trained well, but they are getting new confidence that they can now see the signs that they can keep the field in a protracted conflict.

Incidentally, that is new in my experience in the military. The fiscal year 1987 budget still puts considerable emphasis on sustainability, and rightfully so, because we are not out of the woods yet in a number of categories. We simply must stay the course if we want a genuinely sustainable force, as well as a sophisticated and well-trained one. Otherwise we will be spending a great deal for modern equipment with one hand, and reducing its effectiveness with the other.

Mr. Chairman, my summary is simple. Since World War II, U.S. commanders have understood that in a major confrontation with the Soviets, we would fight outnumbered. We would be outnumbered by men and outnumbered by weapons systems in all services. We have been forced to operate on the theory that we can overcome this disadvantage with modern equipment, with thorough training, quality support and tactics and excellent and skilled people.

Professionals in my generation accept that philosophy and take it as a given, and we think if we have those things we can deter the Soviets despite the fact that we are outnumbered. At the same time, it must be realized that this philosophy from a war fighting perspective leaves little room for error; no latitude to compensate for mistakes. We are operating on a thin margin.

Put simply, what concerns your military leaders is that if in midstream we plateau our modernization effort or start downhill again, that would be bad. We have seen marked improvement over the last few years, but there is a lot yet to be done if you expect your military to overcome the handicap of always fighting outnumbered and expect us to face the future with confidence.

I have heard little disagreement with the need to assess these considerations given military realities. There are other pressures on our Nation, but in my view none so large and dangerous as those I mentioned. Domestic shortcomings and deficits are a serious challenge, and I don't envy you as you grapple with these problems.

I am not a politician, a sociologist or economist, and I would not presume to advise you in fixing those problems. But as a long-time professional in national defense, I can tell you that we are at a critical juncture. If you take the wrong path, it will erode much of the progress that we have made, some of that painfully, and once again permit the Soviets to start widening the military gap between us.

From a military perspective, this would be a serious mistake. Finally, I think it is imperative to convince and keep the Kremlin convinced that we are a credible adversary. Certainly we have to do that if we expect them to be deterred or to talk or to negotiate.

Finally, as the leader of the free world, we must continue to be the bulwark and unifier of our allies so that we can all face the future and profit from our mutual strength.

The President's budget provides a reasonable means to overcome the downturn in 1986 and to take another step toward these key goals. I urge you to stay the course by supporting the fiscal year 1987 budget the President has submitted. That completes my statement, Mr. Chairman.

[Testimony resumes on p. 89.]

[The prepared statement of Admiral Crowe follows:]

PREPARED STATEMENT OF ADM. WILLIAM J. CROWE, JR., USN

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE,

I WELCOME THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE TODAY AND PROVIDE MY ASSESSMENT OF THE NATION'S DEFENSE ESTABLISHMENT. WHILE I AM CONVINCED THAT THE CURRENT POSTURE OF THE ARMED FORCES IS SOUND, I LIKEWISE BELIEVE THERE IS A GREAT DEAL YET TO BE DONE TO INSURE THE NATION'S FUTURE SECURITY -- PARTICULARLY IN THE FACE OF A STEADILY INCREASING SOVIET THREAT AND MOSCOW'S BROADENING USE OF SURROGATES. I AM, OF COURSE, AWARE THAT THERE IS SOME PRESSURE TO CUT BACK DEFENSE APPROPRIATIONS IN AN EFFORT TO ASSIST IN REDUCING THE CURRENT NATIONAL DEFICIT. THEREFORE, I BELIEVE IT IMPORTANT, IN MY FIRST OPPORTUNITY AS CHAIRMAN TO TESTIFY ON THE BUDGET, THAT I COMMENT NOT ONLY ON THE STATUS OF OUR ARMED FORCES, BUT AS WELL ON THE ROLE MILITARY STRENGTH PLAYS IN U.S. POLICY-MAKING AND IN THE AMERICAN RELATIONSHIP WITH THE INTERNATIONAL COMMUNITY. I WOULD STRONGLY ARGUE THAT DELIBERATIONS ON THE MILITARY BUDGET SHOULD COMMENCE WITH A CLEAR UNDERSTANDING OF WHAT OUR DEFENSE ESTABLISHMENT DOES FOR US.

THE ROLE OF U.S. MILITARY STRENGTH

THE SECRETARY OF DEFENSE HAS PROVIDED THE CONGRESS WITH A COMPREHENSIVE STATEMENT OF U.S. DEFENSE POLICY. THAT STATEMENT NOTES, AMONG OTHER THINGS, THAT THE FUNDAMENTAL GOALS OF OUR

NATIONAL SECURITY POLICY HAVE REMAINED ESSENTIALLY UNCHANGED SINCE THE 1940'S:

-- TO PRESERVE THE INDEPENDENCE, FREEDOM OF ACTION AND TERRITORIAL INTEGRITY OF THE UNITED STATES;

-- TO PRESERVE U.S. AND ALLIED VITAL INTERESTS ABROAD; AND

-- TO SHAPE AN INTERNATIONAL ORDER IN WHICH OUR FREEDOMS AND DEMOCRATIC INSTITUTIONS CAN SURVIVE AND PROSPER.

THESE ARE NOT JUST EMPTY WORDS -- THEY GENUINELY DESCRIBE WHAT OUR STRENGTH CAN AND DOES DO FOR US. IT HAS PROVIDED US A GREAT DEAL MORE THAN SIMPLY A SHIELD AGAINST DIRECT ATTACK. THAT SAME POWER UNDERWRITES OUR DEALINGS WITH THE INTERNATIONAL COMMUNITY -- FOR EXAMPLE, TO USE THE SEA LANES, TO COMMUNICATE WITH FRIENDS OVERSEAS, TO APPROACH ARMS CONTROL NEGOTIATIONS WITH CONFIDENCE, AND TO CEMENT ALLIANCES WHICH, IN TURN, ENHANCE OUR OWN SECURITY. IN FACT, OUR STRENGTH HAS BEEN AN INDISPENSABLE PILLAR NOT ONLY OF OUR OWN FREEDOM BUT ALSO THE FREEDOM OF OUR FRIENDS AND ALLIES AROUND THE WORLD.

FOR FIVE YEARS BEFORE RETURNING TO WASHINGTON, I SERVED IN COMMAND BILLETS THAT BROUGHT ME IN TOUCH WITH MOST OF OUR MAJOR ALLIES AND A GOOD SHARE OF THE THIRD WORLD. IN NATO, I OBSERVED FIRSTHAND THAT OUR MILITARY CONTRIBUTION TO THAT COALITION ANCHORS ITS UNITY AND POLITICAL STRUCTURE. WHEN I SERVED AS USCINCPAC, A SUCCESSION OF ASIAN LEADERS EMPHASIZED TO ME THE IMPORTANCE OF A

STRONG AMERICA WITH FORCES FORWARD-DEPLOYED IN THE WESTERN PACIFIC. IN THEIR VIEW, OUR STRENGTH HAS DETERRED SOVIET INTERFERENCE AND INTIMIDATION. BEHIND THAT BULWARK THEY HAVE BEEN ABLE TO SEEK ECONOMIC PROSPERITY AND POLITICAL MATURITY IN THEIR OWN FASHION AND AT THEIR OWN PACE. I WAS CONTINUALLY WARNED THAT A DECIDED SOVIET MILITARY SUPERIORITY IN THE PACIFIC WOULD BE DISASTROUS. IN THE LAST MONTH I HAVE VISITED BOTH CENTRAL AMERICA AND THE MIDDLE EAST. CLEARLY, THE LEADERS IN BOTH AREAS WANT A STRONG AMERICA AS A BACKDROP FOR THEIR EFFORTS TO BUILD FREE AND FUNCTIONING SOCIETIES. TO ALLOW OUR STRENGTH TO DETERIORATE WOULD SERIOUSLY UNDERMINE THEIR EFFORTS AS WELL AS SACRIFICE OUR OWN GOALS.

IN ESSENCE, OUR MILITARY CAPABILITY PROVIDES US A HOST OF BENEFITS IN TERMS OF BOTH NATIONAL SECURITY AND FOREIGN POLICY. EVERY DAY WE ARE REALIZING A RETURN ON OUR INVESTMENT AS THE ARMED FORCES PROVIDE AN UMBRELLA UNDER WHICH ALL OUR OTHER CARDS ARE PLAYED.

THESE CONSIDERATIONS HAVE, OVER THE YEARS, SHAPED OUR GENERAL MILITARY STRATEGY. ITS KEY COMPONENTS ARE:

-- COLLECTIVE SECURITY COUPLED WITH A VIGOROUS OVERSEAS DEFENSE OF THE UNITED STATES.

-- A STRONG AND CREDIBLE STRATEGIC DETERRENT TO EITHER NUCLEAR OR CONVENTIONAL MILITARY ATTACK ON THE U.S. AND/OR ITS ALLIES.

-- CAPABLE FORWARD-DEPLOYED CONVENTIONAL FORCES TO ASSIST

ALLIES AND TO DEAL QUICKLY WITH EMERGING CRISES.

-- A CENTRAL RESERVE TO AUGMENT FORWARD-DEPLOYED UNITS OR DEAL WITH THE UNFORESEEN OVER A WIDE SPECTRUM OF VIOLENCE (TO INCLUDE LOW-INTENSITY CONFLICT AND COUNTERTERRORISM) AND IN A VARIETY OF CLIMES.

-- THE SEA AND AIRLIFT CAPABILITY TO PROJECT AND SUPPORT U.S. FORCES ON A GLOBAL BASIS.

-- THE ABILITY TO ENSURE AMERICA'S FREE AND UNINTERRUPTED USE OF THE SEAS FOR TRADE AND SECURITY PURPOSES.

-- A VIGOROUS SECURITY ASSISTANCE PROGRAM TO AID ALLIES AND FRIENDS IN IMPROVING THEIR ABILITY TO DEFEND THEMSELVES.

-- A WILLINGNESS TO ENGAGE IN MEANINGFUL ARMS LIMITATION NEGOTIATIONS.

THESE PRINCIPLES, OF COURSE, COMBINE TO MAKE UP OUR MILITARY POLICY. GRANTED, IT IS A DEMANDING STRATEGY, BUT ONE THAT BEFITS OUR GOALS AND OUR POSITION AS A LEADER OF THE FREE WORLD. EVEN THOUGH THIS STRATEGY DOES NOT CALL FOR THE U.S. TO MATCH ITS ADVERSARIES WEAPON FOR WEAPON, I OFTEN HEAR THE ARGUMENT THAT WE SHOULD CUT BACK OUR COMMITMENTS TO BETTER FIT OUR RESOURCES. BUT THE PROPONENTS OF SUCH A PHILOSOPHY DON'T SEEM TO BE ABLE TO REACH AGREEMENT ON WHAT COMMITMENTS TO CUT BACK WHAT REGIONS TO NEGLECT OR WHAT ALLIES TO CUT ADRIFT. WITHOUT SUCH A CONSENSUS, THE ARGUMENT HAS LITTLE FORCE -- PARTICULARLY IN TODAY'S INTERDEPENDENT

AND UNCERTAIN WORLD.

THE THREAT

BY DEFINITION, OUR STRATEGY IS DETERMINED NOT ONLY BY OUR OWN INTERESTS BUT ALSO BY THE ACTIONS OF OUR OPPONENTS. AS SECRETARY WEINBERGER EMPHASIZES IN HIS STATEMENT, "IN THIS RESPECT THE SOVIET UNION REMAINS THE DOMINANT CONSIDERATION." MOSCOW STILL HARBORS DREAMS OF UNLIMITED EXPANSION AND OF THE ULTIMATE DEFEAT OF THE FREE WORLD. YET COMMUNISM'S IDEOLOGICAL APPEAL HAS STEADILY LOST GROUND AND THE KREMLIN HAS BEEN PLAGUED WITH A HOST OF INTRACTABLE ECONOMIC AND POLITICAL PROBLEMS. AS A RESULT, SOVIET LEADERS ARE TURNING MORE AND MORE TO RAW POWER TO ACHIEVE THEIR OBJECTIVES EITHER DIRECTLY OR INDIRECTLY -- WITNESS AFGHANISTAN, CAMBODIA, ANGOLA, NICARAGUA, ETC. THE THRUST OF THEIR MILITARY BUILDUP IS AMBITIOUS, HOSTILE TO FREE GOVERNMENTS, AND PERSISTENT.

OVER THE LAST 30 YEARS, EVERY ONE OF MY PREDECESSORS HAS EXPRESSED CONCERN ABOUT THE SOVIET WORLDWIDE THREAT AND THE EVOLVING MILITARY BALANCE. TODAY, THE SHEER SIZE OF CURRENT SOVIET FORCES, AND THE SCALE AND MOMENTUM OF THE KREMLIN'S MODERNIZATION EFFORTS ARE OF SIGNIFICANT CONCERN. TREMENDOUS ADVANCES HAVE BEEN MADE IN HARDWARE OVER THE LAST TWO DECADES, UPSETTING MANY OF THE ADVANTAGES WE HELD IN THE IMMEDIATE POST-WAR PERIOD.

FOR EXAMPLE, THE STRATEGIC NUCLEAR BALANCE HAS SHIFTED DRAMATICALLY. THE SOVIETS NOW ENJOY SUPERIORITY IN ICBMS, MEDIUM-

RANGE NUCLEAR FORCES AND IN MOBILE BALLISTIC MISSILES. THEY ARE A BURGEONING NUCLEAR POWER INTENT ON ACHIEVING DOMINANCE OVER THE U.S. STRATEGIC DETERRENT. AS TO CONVENTIONAL ARMS, THEY LEAD THE WORLD. THE SOVIET INVENTORY INCLUDES ABOUT A 4 TO 1 ADVANTAGE OVER THE UNITED STATES IN TANKS, 2 TO 1 IN AIRCRAFT, AND 5 TO 1 IN ARTILLERY. THESE GAPS WILL LIKELY CONTINUE TO GROW SINCE THE SOVIETS HAVE HISTORICALLY PRODUCED MORE WEAPONS THAN THE COMBINED EFFORTS OF THE UNITED STATES AND NATO. THE PERSONNEL PICTURE IS NO DIFFERENT. ACTIVE SOVIET MILITARY FORCES OUTNUMBER U.S. ACTIVE FORCES BY ABOUT 2 TO 1. SIMILARLY, THEIR PROGRESS IN SPACE COMMANDS DEEP RESPECT; E.G., SATELLITES, ABMS AND ASATS. PERHAPS MOST IMPRESSIVE IS THE RISE OF THE SOVIET NAVY IN THE LAST 30 YEARS FROM A SHORT-LEGGED REGIONAL FORCE TO A BLUE WATER FLEET WITH A GLOBAL REACH. I WON'T DWELL ON STATISTICS BECAUSE RUSSIAN ACCOMPLISHMENTS ARE WELL DOCUMENTED IN OUR POSTURE STATEMENT AND DEFENSE LITERATURE. IN SUM, THIS BUILDUP IS UNPRECEDENTED IN WORLD HISTORY AND ON SHEER MOMENTUM WILL CARRY WELL INTO THE 1990'S, IF NOT LONGER. IN THIS REGARD, IT IS IMPORTANT TO NOTE:

-- SOVIET MILITARY DOCTRINE CONSISTENTLY STRESSES THE OFFENSE AND A "WAR WINNING" PHILOSOPHY.

-- THEIR FORCES VASTLY EXCEED THOSE NECESSARY TO DEFEND THEIR OWN SHORES.

-- THEY ARE TODAY CAPABLE OF WAGING WAR ON TWO FRONTS, BOTH IN

THE EAST AND IN THE WEST.

-- GIVEN THEIR MODERN NAVY AND POLITICAL CONNECTIONS WITH SATELLITE COUNTRIES, THEY NOW HAVE A "GLOBAL MILITARY REACH."

-- THE SOVIETS POSSESS AN OVERWHELMING SUPERIORITY IN THE AREA OF OFFENSIVE CHEMICAL WEAPONS.

-- MOST DISTURBING, THE QUALITATIVE EDGE THE WEST HAS LONG ENJOYED IS BEING ERODED. THIS HAS BEEN ACHIEVED THROUGH LARGE R&D INVESTMENTS, EMPHASIS ON TECHNOLOGICAL EDUCATION (4 TIMES AS MANY ENGINEERS AS THE U.S. IN THE LAST 10 YEARS), PIRACY OF WESTERN TECHNOLOGY, AND A WILLINGNESS TO ACCEPT INEFFICIENCIES IN THE PROCESS.

SPECIAL MENTION MUST BE MADE OF THE INCREASING SOVIET TENDENCY TO ACT THROUGH SURROGATES. THE USSR IS THE WORLD'S LARGEST ARMS SALESMAN, DELIVERING SOME $95 BILLION IN WEAPONS OVER THE LAST DECADE. APPROXIMATELY $80 BILLION WORTH OF EQUIPMENT, SOME NEW AND SOME OUTDATED BY SOVIET STANDARDS, HAS BEEN FUNNELED INTO THE THIRD WORLD DURING THE SAME PERIOD. IN TURN, SOVIET CUSTOMERS ARE EMERGING AS THE MILITARY POWERHOUSES OF SOUTHEAST ASIA, THE MIDDLE EAST, AFRICA, CARIBBEAN, AND LATIN AMERICA. MOREOVER, MOSCOW CONTINUES TO BE SUCCESSFUL IN HAVING ITS CLIENTS ACT AGAINST WESTERN GOVERNMENTS AND PEOPLES. THE RESULT IS A BURGEONING TERRORIST THREAT, MORE SMALL BUT FIERCE REGIONAL CONFLICTS, AND AN INCREASING WILLINGNESS OF SMALL ANTI-AMERICAN REGIMES TO CHALLENGE

WASHINGTON. PERHAPS THIS TREND IS THE RESULT OF OUR SUCCESS IN PRESERVING A ROUGH BALANCE OF POWER WHICH DETERS DIRECT SOVIET ACTION AGAINST THE WEST, BUT THE FACT REMAINS IT PRESENTS A SERIOUS AND GROWING CHALLENGE TO THE U.S. MILITARY.

CONCURRENTLY, WE SEE NEW LEADERSHIP IN THE KREMLIN WHICH APPEARS TO BE REINVIGORATING THE PARTY APPARATUS. WE ALSO KNOW THAT WITH ALL OF ITS MILITARY MUSCLE, THE KREMLIN FACES SOME VERY THORNY POLITICAL, ECONOMIC AND SOCIAL PROBLEMS. HOW ALL OF THIS WILL AFFECT SOVIET BEHAVIOR OVER THE NEXT FEW YEARS REMAINS TO BE SEEN. I AM CONVINCED, HOWEVER, THAT THE U.S. WILL BE IN A FAR BETTER POSITION TO INFLUENCE THE GORBACHEV REGIME IF WE CONTINUE DISCUSSIONS AND NEGOTIATIONS FROM A POSITION OF INCREASING RATHER THAN SAGGING MILITARY STRENGTH.

WHATEVER YOU DECIDE, LET IT BE BASED ON A FULL AND UNEMOTIONAL APPRECIATION OF THE PERIL WE FACE. THESE THREATS CANNOT BE ASSUMED AWAY NOR IS IT NECESSARY TO OVERSTATE THEM. THEY ARE IMPRESSIVE AND OMINOUS IN THEIR OWN RIGHT.

CURRENT STATUS AND THE FY 1987 BUDGET

LET ME NOW MOVE TO THE STATE OF OUR ARMED FORCES. LAST YEAR, GENERAL VESSEY TESTIFIED BEFORE THIS COMMITTEE THAT "BY EVERY COMMON SENSE MEASURE, OUR FORCES ARE MORE READY THAN AT ANY TIME IN THE RECENT PAST." THAT STATEMENT REMAINS VALID TODAY AND IS MADE POSSIBLE BY THE SUPPORT OF OUR CITIZENRY AND THE CONGRESS. ON

BEHALF OF THE MEN AND WOMEN IN THE ARMED FORCES, I THANK YOU. EACH OF THE SERVICE CHIEFS WILL TESTIFY IN SOME DETAIL AS TO THE MAJOR CONCERNS AND THE REQUIREMENTS OF HIS SERVICE. I WILL SPEAK TO OUR OVERALL WARFIGHTING CAPABILITY FROM MY PERSPECTIVE AS CHAIRMAN. TO DO THIS, I HAVE SELECTED FIVE BROAD AREAS OF INTEREST -- MANPOWER, MODERNIZATION, TRAINING, SUSTAINABILITY, AND SPECIAL OPERATIONS FORCES. BEFORE PROCEEDING, HOWEVER, A FEW WORDS ARE IN ORDER CONCERNING THE FY 1986 FISCAL CLIMATE.

AS A RESULT OF A DECISION TO LEVEL DEFENSE SPENDING THIS YEAR AND SUBSEQUENT ACROSS-THE-BOARD CUTS, MANDATED BY PUBLIC LAW 99-177, WE ALREADY HAVE SEEN A NUMBER OF FUNDING DISLOCATIONS WHICH WILL IMPACT ON OUR MILITARY POSTURE. THIS INCLUDES A FIVE PERCENT REDUCTION IN OPERATIONS AND MAINTENANCE FUNDING WHICH IS FORCING SOME BELT TIGHTENING IN SUCH AREAS AS BASE MANAGEMENT, OPERATIONS TEMPO, AND ESSENTIAL MAINTENANCE. FURTHER, WE SEE SOME FREEZES IN CIVILIAN HIRING AS WELL AS REALIGNMENTS IN MILITARY PERSONNEL ROTATION AND TRAVEL ACCOUNTS. WHILE WE ARE STRIVING TO WORK AROUND THESE PROBLEMS, I CANNOT EMPHASIZE TOO STRONGLY THE ADVERSE IMPACT OF SUCH CUTS ON THE READINESS OF OUR FORCES AND THE STABILITY OF MILITARY LIFE. THEY THREATEN TO UNDO MUCH OF WHAT HAS BEEN ACCOMPLISHED IN THE LAST FEW YEARS AS WE HAVE FOUGHT BACK FROM THE NEGLECT FOLLOWING VIETNAM.

MANPOWER. IN PARTICULAR, I WOULD NOT WANT TO SEE REVERSED THE

REMARKABLE IMPROVEMENTS IN OUR MANPOWER SITUATION, WHICH IS THE HEART OF OUR FORCE STRUCTURE. OVERALL, PERSONNEL READINESS IS AT ITS HIGHEST LEVEL OF ANY PEACETIME PERIOD IN OUR HISTORY. ABOUT 50 PERCENT OF THE FORCE ARE CAREERISTS AND AS A RESULT, WE HAVE A SOLID CADRE OF MID-GRADE OFFICER AND ENLISTED PERSONNEL. THE NATION CAN BE EXTREMELY PROUD OF THE HIGH CALIBER OF ITS SERVICE MEN AND WOMEN.

FY 1985 WAS ANOTHER SUCCESSFUL YEAR FOR ALL THE SERVICES. THE QUALITY OF OUR RECRUITS EXCEEDED THAT OF FY 1984. NINETY-THREE PERCENT OF ALL OUR NON-PRIOR SERVICE ENLISTEES WERE HIGH SCHOOL DIPLOMA GRADUATES AND NINETY-THREE PERCENT AS WELL SCORED AVERAGE OR ABOVE ON THE ENLISTMENT TEST. HOWEVER, AS YOU ARE AWARE, THE YOUTH POPULATION FROM WHICH THE SERVICES CAN RECRUIT CONTINUES TO SHRINK, AND RECRUITING CAN BE EXPECTED TO BECOME A GROWING CHALLENGE IN THE FUTURE.

RETENTION CONTINUED AT VERY HIGH LEVELS FOR FY 1985 AS WELL, BUT NOT WITHOUT POTENTIAL WARNING SIGNS. OVERALL, ENLISTED RETENTION DECLINED FROM FY 1984 LEVELS FOR ALL SERVICES IN ALL CATEGORIES EXCEPT FOR FIRST TERMERS IN THE ARMY. THIS HAS AGGRAVATED SHORTAGES IN SOME OF OUR ENLISTED SKILLS. IN ADDITION, THE NAVY STILL IS HAVING DIFFICULTY RETAINING SUFFICIENT NUCLEAR OFFICERS AND, ALONG WITH THE AIR FORCE, CONTINUES TO LOSE EXPERIENCED PILOTS. IN AND OF ITSELF, NONE OF THIS IS CAUSE FOR

GREAT ALARM AT THIS TIME. BUT IT DOES SERVE TO REMIND US THAT PERSONNEL READINESS, RECOGNIZED AS THE CORNERSTONE OF OUR NATIONAL DEFENSE, IS VERY FRAGILE INDEED.

THE BOTTOM LINE IS THAT OUR MOST PRECIOUS ASSET IS QUALITY PERSONNEL; CONSEQUENTLY, AS WE APPROACH THE FY 1987 BUDGET A HEALTHY PERSONNEL STRUCTURE IS THE FIRST PRIORITY OF THE JOINT CHIEFS OF STAFF. IT IS IMPERATIVE THAT WE HAVE PROGRAMS WHICH WILL ATTRACT AND RETAIN ADEQUATE NUMBERS OF DEDICATED, INTELLIGENT AND DISCIPLINED SOLDIERS, SAILORS, AIRMEN AND MARINES. UNDER NO CIRCUMSTANCES CAN WE AFFORD TO RETURN TO THE UNSTABLE MANPOWER PICTURE OF THE 1970'S.

MODERNIZATION -- STRATEGIC NUCLEAR FORCES. TURNING TO FORCE MODERNIZATION, THE UNITED STATES HAS NO CHOICE BUT TO MAINTAIN A CREDIBLE NUCLEAR DETERRENT FOR ITSELF AND FOR THOSE NON-NUCLEAR ALLIES WHO DEPEND UPON IT. STATED IN DIFFERENT TERMS, WE SHOULD BE ABLE TO TELL THE SOVIET UNION: "YOU CANNOT COERCE US WITH YOUR NUCLEAR ARSENALS, BECAUSE IF YOU LAUNCH THOSE WEAPONS YOU WILL SUFFER AS MUCH IF NOT MORE DAMAGE THAN THE UNITED STATES."

UNFORTUNATELY, U.S. STRATEGIC FORCE MODERNIZATION LAGGED FAR BEHIND SOVIET EFFORTS DURING THE 1970'S. AS A RESULT, WE HAVE BEEN FORCED TO REFURBISH ALL THREE LEGS OF THE TRIAD AT THE SAME TIME -- NOTABLY WITH THE PEACEKEEPER MISSILE, THE B-1 BOMBER, AND THE TRIDENT SUBMARINE. CURRENT PLANS CALL FOR PLACING 50 PEACEKEEPERS

INTO MODIFIED MINUTEMAN SILOS. IN ADDITION, WE URGENTLY NEED TO CONTINUE RESEARCH INTO MORE SURVIVABLE MODES FOR BASING THE SECOND 50 MISSILES AND DEVELOPMENT OF A SMALLER ICBM/MOBILE LAUNCHER.

BY THE END OF THIS YEAR, THE FIRST 20 OF 100 B-1 BOMBERS WILL HAVE BEEN DELIVERED TO THE STRATEGIC AIR COMMAND. OVER THE NEXT SEVERAL YEARS, THIS PROGRAM WILL PARTIALLY AND TEMPORARILY MODERNIZE THE MANNED BOMBER ELEMENT OF OUR TRIAD. CONCURRENTLY, WE MUST MOVE AHEAD WITH THE ADVANCED TECHNOLOGY BOMBER (ATB), SO THAT IT CAN BE READY FOR DEPLOYMENT IN THE 1990'S. THEREAFTER, WE WILL HAVE A PRUDENT MIX OF B-1B AND ATB TYPES.

ADDITIONALLY, WE NOW HAVE 5 DEPLOYABLE TRIDENT I SUBMARINES, WITH 2 MORE ON SEA TRIALS. EACH CARRIES 24 IMPROVED C-4 MISSILES. IN VARIOUS PHASES, CONTRACTING AND CONSTRUCTION WORK CONTINUES ON AN ADDITIONAL 6 SUBMARINES FUNDED BY CONGRESS THROUGH FY 1986. THIS BUDGET WOULD FUND THE FOURTEENTH TRIDENT PLUS THE D-5 MISSILE. BECAUSE OF ITS HARD-TARGET KILL CAPABILITY, THE D-5 GOES A LONG WAY TOWARD INCREASING THE POTENCY AND CREDIBILITY OF OUR STRATEGIC NUCLEAR POSTURE.

IN ORDER TO GUARD AGAINST TACTICAL AND TECHNICAL SURPRISE, IT IS ESSENTIAL TO HAVE AN UPDATED AND HEALTHY TRIAD WHICH WILL SEE US INTO THE NEXT CENTURY. THE PRESIDENT'S MODERNIZATION PROGRAM WILL GIVE US THAT CAPABILITY IF IT IS FULLY CARRIED OUT. WE CANNOT AFFORD TO DO OTHERWISE.

LOOKING TO THE FUTURE, THE JOINT CHIEFS OF STAFF WHOLEHEARTEDLY SUPPORT THE PRESIDENT'S STRATEGIC DEFENSE INITIATIVE (SDI) WHICH WILL MUSTER THE NATION'S TECHNOLOGICAL TALENT TO DETERMINE WHETHER AN ALTERNATIVE TO SOLE RELIANCE ON MUTUAL ASSURED DESTRUCTION IS FEASIELE. IT IS BOTH PRUDENT AND MORAL FOR THE UNITED STATES TO EXPLORE MEANS FOR ENDING THE DOMINANCE OF OFFENSIVE BALLISTIC MISSILE WEAPONRY.

MODERNIZATION -- CHEMICAL WARFARE. ADDITIONALLY, THE JCS FERVENTLY SUPPORT EFFORTS INITIATED IN THE FY 1986 BUDGET TO DEVELOP AN UPDATED DETERRENT CHEMICAL CAPABILITY. THIS PROGRAM IS NECESSARY TO OFFSET A SERIOUS DISADVANTAGE ON THE BATTLEFIELD AND TO COUNTER OFFENSIVE AND DEFENSIVE ASYMMETRIES STRONGLY FAVORING THE SOVIET UNION. FROM THE PERSPECTIVE OF THE AMERICAN FIGHTING MAN IN THE FIELD, IT IS DIFFICULT TO OVEREMPHASIZE THIS REQUEST.

MODERNIZATION -- GENERAL PURPOSE FORCES. I HAVE JUST RETURNED FROM EUROPE AND WAS ABLE TO WITNESS FIRST-HAND SOME OF THE MODERN WEAPONS AND EQUIPMENT WHICH HAVE COME INTO THE INVENTORY AS A RESULT OF INVESTMENTS MADE OVER THE LAST SIX YEARS. SIMILARLY, DURING MY TOUR IN THE PACIFIC, WE RECEIVED A STREAM OF MODERN WEAPON SYSTEMS. IT IS MOST IMPRESSIVE AND IS BENEFITTING ACTIVE, RESERVE AND NATIONAL GUARD FORCES ALIKE. MY FY 1987 POSTURE STATEMENT DOCUMENTS THESE ADVANCES IN SOME DETAIL. IT'S NOT JUST QUANTITY WE ARE ADDING BUT QUALITY AS WELL. TEST SCORES IN GUNNERY

AND BOMBING ARE STEADILY CLIMBING, IN GREAT MEASURE BECAUSE OF IMPROVED MUNITIONS AND FIRE CONTROL SYSTEMS FOR USE WITH TANKS, ARTILLERY, FIGHTER AND ATTACK AIRCRAFT AND SHIPS. HIGHER SPEEDS IN THE M-1 TANK AND BRADLEY FIGHTING VEHICLE HAVE PERMITTED A QUANTUM JUMP IN THE PACE OF OUR LAND WARFARE CAPABILITIES. IMPROVED RELIABILITY AND LESS TIME SPENT IN MAINTENANCE ARE CHARACTERISTICS OF THESE NEW WEAPON SYSTEMS WHICH EQUATE TO INCREASED CAPABILITY. SIMILARLY, RECENT INVESTMENTS IN AIRLIFT AND SEALIFT HAVE MATERIALLY ENHANCED THE ABILITY TO PROJECT POWER IN EVERY THEATER. I PERSONALLY WATCHED THE FAST SEALIFT SHIP (ALGOL) UNLOAD IN ANTWERP PORT A FEW DAYS AGO DURING EXERCISE REFORGER. IN SIX DAYS IT MOVED FROM NORFOLK TO WESTERN EUROPE 33,000 MEASUREMENT TONS INCLUDING 1,150 PIECES OF MAJOR EQUIPMENT. EVERYTHING WAS UNLOADED IN 21 HOURS. THE INTEGRATED AEGIS SYSTEM IS AT SEA AND EXCEEDING EXPECTATIONS IN MISSILE KILL CAPABILITY.

WHILE WE HAVE MADE GREAT PROGRESS OVER THE LAST SIX YEARS, IT IS ALSO IMPORTANT TO STRESS THAT WE ARE ONLY MID-STREAM IN THE CONVENTIONAL FORCE MODERNIZATION PROCESS. TO CITE SOME END FY 1985 FIGURES FROM THE ACTIVE ARMY, ABOUT:

-- ONE-THIRD OF OUR TANK BATTALIONS HAVE THE NEW M-1;

-- ONE-FOURTH OF OUR MECHANIZED BATTALIONS HAVE THE BRADLEY FIGHTING VEHICLE;

-- TWO-THIRDS OF AVIATION COMPANIES HAVE THE IMPROVED

BLACKHAWK HELICOPTER; AND

-- ONE-FIFTH OF THE AIR DEFENSE SAM MISSILE BATTERIES ARE EQUIPPED WITH THE NEW PATRIOT.

IN GENERAL, THESE MODERNIZED UNITS GIVE OUR PEOPLE A FAIR CHANCE TO DETER AND DEFEND IN AREAS WHERE THEY MAY BE "FIRST TO FIGHT" AS IN THE CENTRAL REGION OF NATO. BUT THOSE UNITS NOT MODERNIZED -- A MAJORITY OF ACTIVE ARMY BATTALIONS AND MANY IN RESERVE COMPONENTS -- REMAIN BEHIND THE POWER CURVE IN EQUIPMENT QUALITY, PARTICULARLY AS REINFORCEMENTS FOR NATO.

WITH RESPECT TO U.S. TACTICAL AIR FORCES, I FIND SIMILAR TRENDS. OVER THE LAST TEN YEARS, ROUGHLY TWO-THIRDS OF THE AIR FORCE'S TACTICAL FIGHTER SQUADRONS HAVE BEEN MODERNIZED WITH THE F-15, F-16, AND A-10. DURING THE SAME PERIOD, THE NAVY MODERNIZED OVER HALF OF ITS TACTICAL AIR SQUADRONS WITH SUCH TYPES AS THE F-14 OR F-18. FOR BOTH SERVICES, THIS MODERNIZATION PROCESS HAS NOT TRICKLED DOWN AS MUCH OR AS FAST TO THE RESERVES AS WE WOULD LIKE TO SEE.

OUR "BLUE WATER" NAVY ALSO IS ONLY PARTIALLY INTO THE MODERNIZATION PROCESS, PARTICULARLY WITH THE NEW AEGIS-EQUIPPED SHIPS WHICH WILL ADD PROTECTION TO OUR CARRIER BATTLE GROUPS IN TOMORROW'S SOPHISTICATED ELECTRONIC ENVIRONMENT AND HELP COMPENSATE FOR THE SOVIET NUMERICAL SUPERIORITY. ONLY 4 BATTLE GROUPS ARE NOW SO EQUIPPED. IN ADDITION, WE REMAIN MID-STREAM IN EFFORTS TO

MODERNIZE OUR NUCLEAR ATTACK SUBMARINE FORCE WITH ONLY 33 OF THE 688-CLASS IN A FORCE OF 96. IF WE ARE TO FACE THE FUTURE WITH THE CONFIDENCE THAT WE CAN REINFORCE OUR ALLIES, AS ON THE FLANKS OF NATO, OR KEEP SOVIET PRESSURE OFF THE SEA LINES OF COMMUNICATION THEN WE MUST PERSEVERE WITH THESE MODERNIZATION EFFORTS.

IN SUMMARY, WE HAVE MADE GREAT PROGRESS OVER THE LAST SIX YEARS UPDATING OUR CONVENTIONAL FORCES SO THAT THEY CAN SURVIVE ON THE MODERN BATTLEFIELD AND COMPETE WITH THE SOVIET THREAT OF TODAY AND OVER THE HORIZON. MORE PROGRESS WILL BE SEEN OVER THE NEXT TWO YEARS AS EQUIPMENT CURRENTLY IN THE PIPELINE REACHES OUR COMBAT FORCES. BUT IT SHOULD BE CLEARLY UNDERSTOOD THAT WE ARE STILL MID-STREAM IN THE MODERNIZATION EFFORT. TO FALTER NOW WOULD NOT ONLY STRETCH OUT THE ENTIRE PROCESS, BUT WOULD ERODE MANY OF THE GAINS ALREADY MADE AND, FRANKLY, PROVE MORE EXPENSIVE IN THE END. THE FY 1987 BUDGET RECOGNIZES THIS REALITY AND CONTINUES THE MOMENTUM.

TRAINING AND EXERCISES. NEW ACQUISITIONS HAVE BEEN COMPLEMENTED BY A RIGOROUS TRAINING PROGRAM DESIGNED TO CAPITALIZE ON THEIR ENHANCED CAPABILITIES: OUR EXERCISES ARE BRINGING TOGETHER ALL THE SERVICES AND INCREASINGLY INCLUDE NATIONAL GUARD AND RESERVE UNITS. OVER THE LAST YEAR, THE JCS SCHEDULED SOME 95 EXERCISES DESIGNED TO EVALUATE DOCTRINE, TACTICS, PROCEDURES, AND COMMAND AND CONTROL ARRANGEMENTS INVOLVING MULTISERVICE AND MULTINATIONAL COMPONENTS. CONCURRENTLY, OVERSEAS DEPLOYMENT

TRAINING BY ARMY RESERVE COMPONENT SOLDIERS IS UP BY NEARLY 50 PERCENT COMPARED WITH FIVE YEARS AGO.

LIKEWISE, WE ARE STRESSING MORE AND MORE THE LOGISTIC SIDE OF WAR FIGHTING. A FEW EXAMPLES ARE ILLUSTRATIVE. THE REFORGER EXERCISE IN WESTERN EUROPE RECENTLY TESTED EVERY ASPECT OF RECEPTION AND ONWARD MOVEMENT OF REINFORCEMENTS FROM THE CONTINENTAL UNITED STATES USING HOST-NATION SUPPORT FROM OUR EUROPEAN ALLIES. TEAM SPIRIT PERFORMS A SIMILAR FUNCTION FOR THE REINFORCEMENT OF KOREA. CENTRAL COMMAND'S BRIGHT STAR EXERCISE IS GROWING IN REALISM EVERY YEAR AND ENHANCING OUR ABILITY TO PROJECT POWER INTO THE MIDDLE EAST. THESE ARE JUST THE TIP OF AN EXERCISE ICEBERG. IN SUM, OUR TRAINING IS STEADILY BECOMING MORE JOINT, REALISTIC AND INNOVATIVE.

SUSTAINABILITY. OTHER IMPROVEMENTS CAN BE SEEN IN THE SUSTAINABILITY OR COMBAT "STAYING POWER" OF OUR FORCES. AS A SYSTEM, SUSTAINABILITY INCLUDES WAR RESERVE STOCKPILES (MUNITIONS AND SPARES), TRANSPORTATION CAPABILITIES, AND INDUSTRIAL SURGE CAPACITIES. WE WORRY ABOUT POTENTIAL "WAR STOPPERS" OR THEIR IMPACT ON THE THEATER NUCLEAR THRESHOLD. THUS, OUR GOAL IN SUSTAINABILITY IS "LOGISTIC SUPPORT TO OUR CONVENTIONAL FORCES FROM INITIATION TO SUCCESSFUL TERMINATION OF ANY CONFLICTS."

IN LINE WITH THIS GOAL, WE HAVE SEEN SUBSTANTIAL GROWTH IN U.S. EXPENDITURES FOR SUSTAINABILITY OVER THE LAST SIX YEARS. IN

THE PAST FOUR YEARS, THE FUNDING FOR AMMUNITION HAS GROWN BY OVER 25 PERCENT; SPARE PARTS FUNDING HAS DOUBLED; AND AMMUNITION INVENTORIES OF ALL SERVICES HAVE IMPROVED SUBSTANTIALLY. IN EUROPE, FOR INSTANCE, GROUND AMMUNITION TONNAGE IS UP 18 PERCENT, AND IT HAS ALMOST DOUBLED IN THE PACIFIC. MUNITION DEFICIENCIES WHICH PLAGUED US FOR YEARS ARE IMPROVING STEADILY, BUT AT THE CURRENT RATE OF EXPENDITURES, IT WILL BE SEVERAL YEARS BEFORE WE CAN NEAR OUR GOALS AND BREATHE EASIER.

THE FY 1987 BUDGET STILL PUTS CONSIDERABLE EMPHASIS ON SUSTAINABILITY AND RIGHTFULLY SO. BUT YEARS OF NEGLECT CANNOT BE REMEDIED EASILY OR QUICKLY. WE SIMPLY MUST STAY THE COURSE IF WE WANT A GENUINELY SUSTAINABLE FORCE AS WELL AS A MODERN AND WELL-TRAINED ONE. OTHERWISE, WE WILL BE SPENDING A GREAT DEAL FOR MODERN EQUIPMENT WITH ONE HAND AND THEN REDUCING ITS EFFECTIVENESS WITH THE OTHER.

SPECIAL OPERATIONS FORCES. A PARTICULAR WORD ABOUT "SPECIAL OPERATIONS FORCES" IS IN ORDER. WHILE SMALL IN TOTAL STRENGTH, OUR SPECIAL OPERATIONS FORCES HAVE ENORMOUS UTILITY AND VALUE IN PEACE, CRISIS, OR WAR. SOME ARE SPECIFICALLY TAILORED, DEDICATED, AND READILY AVAILABLE TO PROTECT AMERICAN LIVES AND PROPERTY OVERSEAS AGAINST INTERNATIONAL TERRORISTS OR OTHER NON-GOVERNMENTAL GROUPS HOSTILE TO THE UNITED STATES.

SOF UNITS ARE COMPRISED OF THE U.S. ARMY SPECIAL FORCES AND

RANGER BATTALIONS, U.S. AIR FORCE SPECIAL OPERATIONS FORCES AND THE U.S. NAVY SEAL TEAMS. MAJOR EQUIPMENT INITIATIVES IN TRAIN INCLUDE MORE HELICOPTERS WITH SPECIALIZED MISSION EQUIPMENT, IMPROVED AC-130 GUNSHIPS, AIR TRANSPORTS, LONG-RANGE COMMUNICATIONS, DRY-DECK SHELTERS ON SUBMARINES, AND SEAL DELIVERY VEHICLES, ALONG WITH RELATED SUPPORT FACILITIES.

OVERALL, THE PROGRAM REMAINS ON TRACK IN FY 1986 WITH:

-- AN INCREASE IN ARMY CONTINGENTS INCLUDING CH-47D HELICOPTERS AND RELATED SUPPORT;

-- EXPANSION OF THE NAVY'S SPECIAL WARFARE TRAINING SCHOOL AND NUMBER OF SEAL PLATOONS; AND

-- NEW EQUIPMENT ACQUISITIONS BY THE AIR FORCE TO UPGRADE THE SOF AVIATION SUPPORT FLEET.

SIMULTANEOUSLY, CONSIDERABLE THOUGHT HAS BEEN PUT INTO THE COMMAND AND CONTROL PROBLEM. I AM PERSUADED THAT WE NOW HAVE A SYSTEM WHICH GIVES US CONSIDERABLE FLEXIBILITY AND PERMITS US TO EXERCISE WHATEVER DEGREE OF OPERATIONAL SUPERVISION IS INDICATED BY THE CIRCUMSTANCES.

ESSENTIALLY, WE HAVE MADE REMARKABLE IMPROVEMENTS IN SOF CAPABILITIES AND READINESS SINCE THE EARLY 198[illegible]S. I ALSO SUPPPORT THE INCREMENTAL APPROACH TOWARD IMPROVEMENT EMBODIED IN THE GENERAL SOF REVITALIZATION PROGRAM AND IN THE PARTICULAR FY 1987 SUBMISSION. MANY SPECIALIZED AND UNIQUE CAPABILITIES SIMPLY CANNOT

BE ACHIEVED ON A "CRASH" BASIS. THE PROGRAM WILL REQUIRE CAREFUL MONITORING AND MANAGEMENT OVER THE NEXT FEW YEARS TO ENSURE THAT VARIOUS COMPONENTS OF THE REVITALIZATION EFFORT REMAIN ON TRACK.

OVERALL CAPABILITY

OVERALL, THE WARFIGHTING CAPABILITY OF THE U.S. ARMED FORCES, ACTIVE AND RESERVE, REMAINS AT A HIGH STATE. KEEPING IT THERE REQUIRES US TO FOCUS ON TWO FACTS OF LIFE:

-- ONE, READINESS IS A COMPOSITE OF SEVERAL FACTORS: COMBAT EQUIPMENT, PERSONNEL, MAINTENANCE, EXERCISES, AND SUPPLY LEVELS. AS GENERAL GEORGE BROWN OBSERVED EXACTLY TEN YEARS AGO, NEGLECT IN ANY ONE OF THESE AREAS CAN STRESS SEPARATE PARTS OF THE SYSTEM WITH AN IMPACT ON OVERALL POSTURE. THE PROCESS OF DETERIORATION MAY SEEM GRADUAL, BUT THE BREAKDOWN IN CREDIBLE MILITARY CAPABILITY, SHOULD IT OCCUR, WOULD BE INSTANT.

-- READINESS DOES NOT DETERMINE BY ITSELF HOW WELL A FORCE WILL ACQUIT ITSELF IN COMBAT. A FORCE LESS THAN FULLY READY MAY DO VERY WELL. CONVERSELY, A 100 PERCENT READY FORCE STILL MAY NOT HAVE ADEQUATE MILITARY CAPABILITY BECAUSE OF QUANTITATIVE OR QUALITATIVE DEFICIENCIES IN FORCE STRUCTURE.

THE OBVIOUS CONCLUSION IS THAT FORCE STRUCTURE AND READINESS ARE NOT AN EITHER/OR PROPOSITION. WE NEED TO BE STRONG IN BOTH AREAS. THE PRESIDENT'S BUDGET FOR FY 1987 STRIKES SUCH A BALANCE.

SUMMARY AND CONCLUSIONS

IN SUMMARY, MR. CHAIRMAN, OUR MILITARY POSTURE TODAY IS DRIVEN BY A NUMBER OF REAL-WORLD DEMANDS, MANY OF WHICH HAVE EVOLVED OVER THE LAST 30 YEARS. IF ANYTHING, WE HAVE BECOME MORE RATHER THAN LESS DEPENDENT UPON GLOBAL PEACE AND SECURITY THAN WE WERE TWO OR THREE DECADES AGO. LAYERED ON TOP OF THESE DEMANDS IS A SOVIET THREAT WHICH HAS STEADILY INCREASED OVER TIME IN ALL DIMENSIONS OF MODERN WARFARE AND IN ALL OF THE REGIONS WHICH CONCERN US MOST. IN THIS ENVIRONMENT, I SEE NO SUBSTITUTE FOR PEACE THROUGH STRENGTH. FURTHER, I BELIEVE THAT THE PROSPECTS OF INFLUENCING THE SOVIET UNION TOWARD A CONSTRUCTIVE POSTURE IN WORLD AFFAIRS WILL DEPEND INEVITABLY UPON OUR CAPABILITY TO NEGOTIATE FROM A POSITION OF STRENGTH, BOTH TODAY AND OVER THE LONG HAUL.

BEYOND THESE STRATEGIC IMPERATIVES, THE PRESIDENT'S BUDGET FOR FY 1987 HAS SEVERAL OTHER MILITARY QUALITIES WHICH I SUPPORT:

-- IT STRONGLY EMPHASIZES THOSE CAPABILITIES ESSENTIAL TO U.S. SECURITY WHILE COVERING OTHERS WHICH ONLY WE CAN PROVIDE AS A SUPERPOWER AND AS A PARTNER IN GLOBAL SECURITY ARRANGEMENTS.

-- IT CONTINUES TO FLESH OUT ESSENTIAL IMPROVEMENTS IN OUR STRATEGIC NUCLEAR AND CONVENTIONAL FORCE STRUCTURE, ALONG WITH NEW INITIATIVES IN THE HIGH FRONTIERS OF TECHNOLOGY AND IMPROVEMENTS IN MILITARY COMPENSATION.

-- IT MAINTAINS A CAREFULLY CRAFTED BALANCE BETWEEN EQUIPMENT

MODERNIZATION, PERSONNEL READINESS, TRAINING AND EXERCISES, MAINTENANCE AND SUPPLY, AND SUSTAINABILITY.

-- IT PROVIDES THAT GROWTH NECESSARY NOT ONLY TO CONTINUE IMPROVEMENTS IN OUR MILITARY POSTURE BUT ALSO TO LEAD OUR ALLIES TOWARD A SIMILAR COMMITMENT OF RESOURCES. AND MOST IMPORTANTLY IT SENDS A STRONG MESSAGE OF DETERRENCE TO OUR ENEMIES.

THIS IS NOT TO SAY THAT THIS BUDGET ELIMINATES RISK. OUR CHALLENGES ARE MANY AND OUR ADVERSARIES ARE LARGE, POWERFUL AND DEDICATED. ON A TYPICAL DAY, WE HAVE ROUGHLY 475,000 SOLDIERS, SAILORS, AIRMEN, AND MARINES SERVING ON OR AROUND THE EURASIAN CONTINENT -- ESSENTIALLY WHERE OUR FORWARD DEFENSE COMMITMENTS ABUT OR OVERLAP THE FORWARD POSTURE OF SOVIET ARMED FORCES. WE COUNT ON THESE AMERICANS AND OUR ALLIES TO DETER IN A VERY HIGH THREAT ENVIRONMENT. WE ALSO RECOGNIZE THAT THEY MUST BE BACKED UP BY CAPABLE AND READY FORCES IN THE U.S. FOR BOTH DETERRENCE AND DEFENSE PURPOSES. YET, OVER THIRTY-FIVE BILLION DOLLARS HAS BEEN REMOVED FROM THE FY 1986 BUDGET FROM WHAT WE COUNTED ON JUST A YEAR AGO. THIS IS NEGATIVE REAL GROWTH OF ABOUT 6 PERCENT. DECREMENTS OF THIS NATURE REQUIRE SIGNIFICANT CHANGES AND REBALANCING. THE PRICE IN DEFENSE IS IN STRETCHING OUT AND INCREASING THE COST IN MODERNIZATION AND IN REACHING SUSTAINMENT GOALS. WE WILL ALSO GIVE UP MORE DESIRABLE LEVELS OF FLYING HOURS, COMBAT VEHICLE MILEAGE AND STEAMING DAYS. WE ARE HITCHING UP OUR BRITCHES AND TAKING A GREATER RISK. BUT THIS IS AS FAR AS I ADVISE WE GO. WE NEED A BALANCED PROGRAM THAT ALLOWS FOR SOME REAL GROWTH IN FY 1987. THE PRESIDENT'S BUDGET DOES THAT.

The CHAIRMAN. Thank you very much, Admiral Crowe, and also, Secretary Weinberger.

Let me announce that we will be operating on the 5-minute rule, and I will basically try to maintain that even for the Chair. I really want to ask two questions.

Mr. Secretary, in your testimony you made a great deal to do about the 6 percent cut that you perceived from the so-called agreed level of funding for the Pentagon in the fiscal year 1986 budget. There is some question as to whether there was an agreement. I don't recall the President ever calling me and endorsing the agreement worked out between myself and Mr. Domenici on the $302.5 billion, but be that as it may, the question I want to ask is about the 6 percent cut that you mentioned in the 1986 figure. Was that cut not the result of the Gramm-Rudman agreement in the 6 percent coming up, and isn't it true the President endorsed Gramm-Rudman?

Let's look at it a little differently. Since 1980 the Pentagon budget authority has gone from $145 billion to your fiscal year 1987 request of $320 billion. If you add up the cumulative increase in these years over the fiscal year 1980 level, $145 billion, you would find that there has been an increase of $790 billion.

Would you say, Mr. Secretary, that the 6 percent you are talking about, which I know is real from your point of view, is the result of that Gramm-Rudman law which the President endorsed?

Mr. WEINBERGER. Mr. Chairman, about 2.2 percent of it is the result of the action of the Congress. When the Congress finished with our budget in 1986, it was about 2.2 percent below zero real growth, the amount which had been promised and agreed to in the congressional budget resolution which the President did endorse and did accept.

When Gramm-Rudman's automatic reductions came in, it drove our budget down another 4 percent, so the final result is a 6.2-percent real reduction. It is minus real growth. It is the first time in 15 years that the defense budget has been lower in 1 year than the previous year. And it caused very serious problems. But it is a combined result of the automatic action of Gramm-Rudman and the Congress' action before Gramm-Rudman took effect in fiscal year 1986.

The CHAIRMAN. I think that my point simply to you, Mr. Secretary, is that the Budget Committee sets a ceiling of $302.5 billion. Then the appropriation and authorizing committees must make decisions as to whether they go to that full level. As you are pointing out now, the Congress in its wisdom, both the House and the Senate, decided not to go to that full level, and that is the result of the 2.2 percent. Therefore, the major part of your 6 percent is the result of the Gramm-Rudman mandates which the President himself endorsed.

So it is a little misleading to—I know you are not saying this and you clarified it, and that is why I asked the question—but from your testimony it was as if Congress had purposely reduced you 6 percent when, in fact, the President endorsed Gramm-Rudman and 4 percent of that 6 percent comes from that.

Mr. WEINBERGER. Mr. Chairman, the President, of course, signed the bill, but whether the Congress meant to do it or not, the result

with much we have to work and the Nation has to contend is that defense expenditures, measured in real terms, went down by 6.2 percent against an agreement reached a few months before that, that they would be at zero.

Unfortunately, we have to look at the results, and we have to try and deal with them. That is the result.

The CHAIRMAN. I understand your point of view, and you are right from your point of view. But I want to have the record straight, and that is that the President did not simply sign Gramm-Rudman. He endorsed it before there was even a vote in the final passage of the House. Therefore, 4 percent of your losses are from the actions of the President, and I do not want the public to have the impression that it was detrimental action taken arbitrarily by the Congress.

You would be right in your estimate when you say 2.2 percent was taken from the Congress, but not the entire 6 percent. Let me move to my second question. As you know, Mr. Secretary, this year we have a new budget act. That is what we just talked about, 4 percent of your loss was Gramm-Rudman. Gramm-Rudman requires some changes in the Budget process.

As Budget chairman, one of those changes I see is that we must be very accurate as we make our estimates. We must be as accurate as possible because, unlike in the past, now if we are incorrect, something drastic will happen. What will happen is OMB, CBO, and GAO will tell us we missed the Gramm-Rudman target for 1987 of $144 billion, and then the great sequester will come riding out of—I guess if it is attacking the Pentagon budget, he will be riding out of the East and thus cut rather drastically the Pentagon budget.

I am not for the sequester coming out of the East or the West, or the North or the South. But the reality is if we are to avoid that, all of us in this process, both in the executive branch as well as the congressional branch, must have a new degree of realism in our estimates. It is my view, and my staff's view, that as we look at the budget submitted to us by OMB on Wednesday, that the President's budget does not meet with the law of Gramm-Rudman. Nor does it hit a target of $144 billion because it is our view that there has been an estimation of outlays for defense spending for fiscal year 1987 of $14 billion.

Would you please explain what appears to be a significant discrepancy between the outlay estimates and also the estimates of my staff, which by the way, Senator Domenici on national television Wednesday evening to some degree concurred with. Also, do you feel that your estimate of outlays are correct? I understand that they are a guesstimate, but we have to be very accurate this year because the law requires it.

Mr. WEINBERGER. I have every confidence that they are correct, Mr. Chairman, because they came from this committee and from the congressional budget resolution which the Congress approved.

We are using the figures given to us by the congressional resolution of last August with respect both to authorization and to outlays. We came in $3 billion below the amount we were told to come in for budget authority just as recently as August. We are in at

$311 billion. The Congress told us to come in at $314 billion. We are coming in with the outlay estimates derived from that.

Congress said $274 billion, and we are right at $274 billion for outlays. So we start with that. We start with the second point, that outlay figures are estimates. They are simply estimates. Now, we are estimating somewhere between 22 and 27 months ahead as to what the actuals will be. There has been one continuing characteristic about outlay estimates ever since I have had the opportunity and honor of working in Government positions, and that is that outlay estimates are always wrong. It is inevitable that that will be the case, because you can't estimate with any precision what is going to happen 2½ years ahead of time.

Outlay estimates are based upon historical relationships between budget authority and spending, and that is one of the ways you try and construct them. In the past they have been estimates, and everybody understood that, and they gave us a basis for trying to plan. And we also had to be very flexible. This year, as you point out, the estimates that are required under Gramm-Rudman will take on a mystical significance, if you will, of their own. They will be extremely important, because whether they are accurate or not—and they are bound to be inaccurate because of the length of time involved—they will require certain actions to be taken.

If they come out one way, they will cause the so-called trigger on Gramm-Rudman to be pulled, and very drastic reductions in spending will have to be made right across the board. They will provide ammunition for people to urge that taxes must be imposed.

About 20 months later, we may find out the estimates are wrong, as usual, and that we don't have that size deficit, and that we didn't need to make the cuts we did. What I am trying to emphasize is that we have to start somewhere with outlay estimation. The outlay estimation we started with is what we got from this committee.

There is also, I think, a basic problem in the fact that the figures I have been given by your staff and that we see appearing from various other sources are based on computer runs of the historical relationship between authority and outlays. There are a lot of new factors this year that change those computer runs, because we have different conditions than they are based on.

The first is, of course, Gramm-Rudman itself. That has injected a great deal of uncertainty into the process, into the action of the services at our Department, and I am sure the same is true with the rest of the Government.

We are starting out with a lot of hesitation that wasn't in the process before, before incurring obligations, meeting expenditures, and paying bills. The continuing resolution enhanced a lot of that uncertainly in program management actions because it represents cuts even before Gramm-Rudman.

Then we have a substantial amount that we have, in effect, had to put on hold, because we don't know what the final actions will be this year even on existing contracts. Some of those contracts may have to be canceled if the cuts are too drastic, and that will incur various cancellation penalties. So rather than making particular outlays at a given time, we will have to hold them for a lot longer time.

I have made a major change in the payment regulations of the Department by reducing progress payments on existing contracts to 80 percent from 90 percent, a 10-percent reduction in those progress payments.

That will have a major effect on the actual rate of outlays and the type of outlays. We will have changes in the kinds of spending we are doing in the Department, and that affects the timing of outlays. We have had an increase in the kinds of things that outlay much slower than other things. We have had, for example, reductions in our request for force strength and force strength outlays more rapidly than other kinds.

We are sharply reducing the use of so-called unpriced contracts which again are things that cause outlays to occur somewhat more rapidly even though the total is limited. You also have these very subtantial new audit procedures that we put in, requiring a great deal more clarification of requests for payment compared to past years and that has slowed things down.

What I am saying, Mr. Chairman, is we took the figure you told us to take. We have several factors that make it clear that the outlays will be lower than in those figures you gave us to use, and I see no basis whatever for assuming that the outlays are going to be 20 percent or 10 percent or $20 billion, or whatever higher. I think exactly the contrary.

The CHAIRMAN. Well, thank you, Mr. Secretary, for that answer, but let me just say a couple of things. My grandmother used to tell me two wrongs don't make a right, and if the committee made a mistake last year in our budget resolution in underestimating outlays and particularly on Gramm-Rudman, we certainly don't want to make that same mistake.

CBO has said that you are right that we all made a mistake in underestimating outlays for 1986. That is why OMB and CBO said the budget deficit was going to be $220 billion, and thus kick in sequestration. One of the reasons was the underestimate of spending in the Pentagon accounts, as well as agriculture.

Mr. WEINBERGER. Mr. Chairman, I don't—if I may——

The CHAIRMAN. Let me just finish.

Mr. WEINBERGER. I don't think OMB said that. I think OMB's estimate of the deficit is what is in the book.

The CHAIRMAN. I think OMB said 3 weeks ago, Mr. Secretary, that we had a bulge in the deficit that took us to $220 billion; CBO agreed. They were off by $200 million or $300 million, but there was general agreement. That is why they ordered the sequestration to hit on March 1, which the President in his radio address said that he signed. However, that is not the issue.

The issue, Mr. Secretary, is that you drew it from what was done last August when we know that those estimates were incorrect, and we know that our present process is going to devastate national security if we are wrong.

Let me just give you a couple of examples of what I am talking about based on the defense budget. We also understand that OMB sends it, and I thought maybe OMB had done this. I am not accusing you, but in your O&M account, operation and maintenance, there is an increase of $11.5 billion in budget authority. The Penta-

gon shows a new outlay of $5.7 billion as a 49-percent first-year outlay rate.

The standard CBO first-year outlay rate is 78 percent, which would result in a first-year outlay of $9 billion. Thus in that one account, you could potentially——

Mr. WEINBERGER. Could I comment on that, Mr. Chairman.

The CHAIRMAN. I will give you a chance to answer. All right.

Mr. WEINBERGER. All right.

The CHAIRMAN. That would be an underestimation of $3.3 billion. Let's go to another one. In personnel, there is a $9.1 million increase in budget authority, the Pentagon, or OMB, I don't which one, but it is in the budget—shows a new outlay of $4.8 billion as a 53-percent first-year outlay rate. The standard CBO first-year outlay rate is 97 percent, which would result in a first-year outlay of $8.8 billion.

Of course, we spend the personnel accounts faster, a Pentagon estimate then of $4 billion. Those are just two examples. I would also conclude and let you respond, Mr. Secretary, to something that I have just received. I asked the Congressional Budget Office to look at the outlay expenditures historically as well as for fiscal year 1986 and look at the President's budget and here is the letter from the CBO and it says, "The preliminary estimates show outlays at about $269.4 billion in 1986 and our estimate exceeds those of the administration by $3.6 billion, and $14.7 billion for 1986 and 1987 respectfully."

So, thus, my staff says $15 billion; CBO says that their reestimate at this particular point is $14.7 billion. Now, they also go on, and I want to give you the benefit of the doubt. They say that this may change, but my point, Mr. Secretary, is that there is a substantive difference, a significant difference, and under Gramm-Rudman has significant implications for the very national security that you and I want to protect.

Because, if we are wrong in August, we will be told by the same agency what the exact account will be. It seems to me, Mr. Secretary, that OMB and the Pentagon need to sit down and rethink these figures so that we will not bring the sequester down on national security. Since you stated in your opening statements that it would be an absolute disaster, and I agree with you.

Explain to me how we could have—I understand you have done some things on O&M—but personnel accounts spend fast. CBO says your $14.7 billion, therefore, the President's budget does not comply with Gramm-Rudman.

Mr. WEINBERGER. Mr. Chairman, I am glad to have the opportunity to comment. I certainly agree with you that we should not allow sequestration under the Gramm-Rudman Act to take place again. It has caused enough problems, and enough very serious losses in 1986.

The relationship between budget authority and outlays, as I say, is historical. It is based on historical averages just as the outlay estimates are estimates, and based upon those same historical averages. You are right that OMB is the one that does give us the estimated outlay numbers based on budget authority. What we have done is start with the figures this committee gave us, assuming that those had some substance and then try to apply the new fac-

tors that are present in the situation this year. And I have spent a great deal of time, perhaps, answering your question at much too great length—discussing all the new factors that are present.

About the only one I left out is the fact that we have these far more stringent auditing requirements, and that slows down the process of payment. Outlays on contracts are a function of the time of payment. Ultimately, whatever your budget authority calls for has to be spent unless you are able to do as we have done, and that is get a lot more defense for the authority. Then that authority is turned back to the Treasury, which we have also done to the tune of about $8 billion last year, I believe.

The point here is that on these various estimates, O&M and so on, we are planning a somewhat slower tempo of operations that will reduce outlays in fiscal year 1987. The authority is there. We will use it ultimately, but we are planning for outlays so that they will come out within the figures we have spoken about.

I don't have the figures before me on the estimated outlays from the personnel account. We will certainly look that up. We will provide that.

[The following information was supplied for the record:]

DOD Fiscal Year 1987 Budget Request

There is only a small difference between the outlay rate used by CBO and OSD for Military Personnel. CBO's first year outlay rate is 97.0 percent and OSD's rate is 97.8 percent. The fiscal year 1986 outlays were computed against the total funds available to include budget authority and $4.5 billion from proposed unobligated balance transfers from other DOD appropriations.

Mr. Weinberger. The important point, however, is that wherever we stand on the outlay estimates, we can make them work. If we don't try to deal with them and simply let them go, they could go higher or they could go lower. In previous years when I was involved with the economy and the Government as a whole, I have had a lot of worried calls from various people saying we ought to increase Government outlays as a whole to stimulate the economy.

That can be done, too. The important thing is that these are estimates. They are our best estimates. They start with the committee's own data, and I think they are fully supportable. I agree with the last paragraph of the CBO letter—that these tentative estimates may change during the next 2 weeks as we refine our computation, and as we learn more about the President's proposal.

The Chairman. I would simply say, Mr. Secretary, I did quote that part of the CBO letter that it could change, but in my conversation with experts based on historical experience, particularly in 1986, the change would probably be upward. How are you going to delay outlay expenditures and personnel accounts unless you ask the armed services people not to cash their checks for a couple months? You might slow it down.

Mr. Weinberger. You don't do it in personnel accounts, Mr. Chairman.

The Chairman. My concern is that this kind of misestimate, missing the target, sets the President up, sets this Nation up for exactly what we don't need to have happen, which is sequestration of defense. Therefore, Mr. Secretary—and I know OMB has a role

in this, and I am sorry that I don't have Mr. Miller here to also ask him this question, but I am going to ask him.

Therefore, I really feel constrained as chairman of the House Budget Committee, to call upon the President to resubmit his budget because it doesn't meet the target of Gramm-Rudman at $144 billion, and to straighten out the estimates because if not, we are going to be heading to a situation where that which you care a great deal about and have worked so tirelessly for, could fall under sequestration in August, and that would be a disaster.

I would just hope that you could convince the President and Mr. Miller to reexamine this, because I can tell you right now Members of Congress are going to have a very difficult time, at least members of this committee, passing a budget that has a questionable outlay expenditure that puts it way into the 150's and at the same time know that you have sequestration. Because that would mean, sir, in August you would have to find $15 billion more or $10 billion more additional cuts in domestic programs following the fiscal policy of the administration.

Mr. WEINBERGER. Mr. Chairman, I would just say once more that we don't believe the estimates are wrong. We believe that there is an ample amount of change in the situation this year so that the use of computerized historical analyses is no longer valid as a way to compute the estimated outlays.

We believe these estimates are as accurate as they can be. There is no question, thinking of how many other years we have made budgets, that they will come out precisely. They never do. But they are the best we could do now, and they do indicate the President's budget does meet the Gramm-Rudman target of a $144 billion deficit this year if it is enacted.

So we ask you again that it be enacted, and that the defense budget be sustained as what is needed for the country, rather than getting into a lot of reductions based on somebody's estimate that we know is going to come out inaccurately. The estimate that we have in the budget is the best that can be done 27 months ahead of time. It is based upon the facts that, as I say, started with this committee and have been refined by the application of the new factors that were not involved in the historical analyses that gave rise to some of the predictions that these estimates might be low.

The CHAIRMAN. Thank you, Mr. Secretary. I am going to yield to our ranking minority member, Mr. Gradison, but I would have to say the estimates are not right. CBO has said they are not right. Senator Domenici announced publicly that he has grave misgivings. So I will be asking the President to resubmit his budget, or at least this part of it, if he expects to have us be able to move forward.

I want the President to have ample opportunity to have that budget reviewed, every aspect of it, and also have it voted on. However, if you submit a budget that is not within the law, then somebody is going to get up and raise a point of order, which they can do under Gramm-Rudman, and say this budget cannot be considered because it doesn't meet the law and I don't want that to happen to our President and to his budget. Mr. Gradison.

Mr. GRADISON. Thank you very much. Mr. Secretary, as you know, in this committee we have to focus on numbers because ulti-

mately we come up with a single number for the defense function. But I really am troubled just focusing on numbers rather than on programs. I have had my frustrations with your Department in the past because of difficulty of getting from the Department of Defense a list of your own priorities which would let us know what we would get as a nation in the way of a stronger defense, if we spent more, and what we would get if we spent less.

Because, as I said earlier, this year is frontloaded, decisions we make, if at all, will have to be made earlier than usual. We are working very hard on our side of the aisle to stay in very close touch with our membership, and get a sense of where they are coming from on these budget numbers.

I would like to indicate to you that the early indications that I have, though I cannot speak for anyone but myself, is that on our side there is a sentiment toward a freeze either at the real current level or at a nominal current level even as bad as that nominal current level will be.

If you say, and I would agree with you, that that is going too far, and if you have to make that choice that a real freeze at 1986 levels certainly is better than a nominal freeze, I would like to ask you will you be in a position to present to us, if not now, within the next couple weeks, a specific list of what you won't be able to do if we approve a budget at the real freeze Gramm-Rudman-Hollings 1986 level which would be at the $288 billion budget authority level?

Just give us a list of what you won't be able to do to help us make a decision as to whether that is a wise course of action.

Mr. WEINBERGER. It is very simple, Mr. Gradison. Our priorities, and we have said it repeatedly, and people are always saying we don't, are simple. They are to complete the President's strategic modernization program, to advance the research on strategic defense, to protect all of our people to the greatest extent Congress will let us, with respect both to salary and increases required by inflation, and to the numbers of people that we require to operate the things the Congress has authorized and we have bought.

And we will try to do whatever we can in the way of maintaining readiness and sustainability, and a higher operating tempo, and to deal with whatever crisis happens to come up at the moment in any part of the world.

So those are the priorities. When you ask what will we have to cut back if we continue this decline—what you have to cut back then is certainly operation and maintenance, building up backlogs that we had just about eliminated—backlogs that were all there during the Carter years.

You have to give up training. You have to give up some of your ammunition reserves.

And then you start cutting back into—you can't do it all with those accounts—you start cutting back on personnel. You have to let some of the forces go, whereas you should increase them.

You have to stretch out or delay some of the necessary modernization of the triad which urgently needs modernization, and for which we have entered into contracts that enable us to acquire the most economic rates of production. And then you have to start cut-

ting back on strategic defense, then you have the effect of all that on arms reduction talks, and——

Mr. GRADISON. Secretary——

Mr. WEINBERGER. If I could finish, since you asked the question.

Mr. GRADISON. I don't think you have answered it; that is why I would like to interrupt. Can you give us numbers, so many of this aircraft, so many of a percent, what parts of the world it would be in, et cetera?

Mr. WEINBERGER. I can tell you exactly what we did not buy this year——

Mr. GRADISON. That is not the question——

Mr. WEINBERGER [continuing]. That you wanted us to buy.

Mr. GRADISON. That is not the question, Mr. Secretary. The question is, What will you be unable to do next year if the Congress were to decide that the budget authority figure for function 050 for fiscal year 1987 was to be $288 billion?

Now, you have given an excellent general statement. I appreciate it. But I don't think it is specific enough for this member.

Mr. WEINBERGER. Let me translate it then into the things that have to be cut. We have to cut back on training time, so instead of getting the number of flying hours we have now we would probably have 20 percent less. We would have less ammunition. We would buy fewer airplanes. We would——

Mr. GRADISON. Which ones ?

Mr. WEINBERGER. F-15, 16.

Mr. GRADISON. How many?

Mr. WEINBERGER. F-18's.

Mr. GRADISON. How many?

Mr. WEINBERGER. It would depend entirely on the mix of what the services recommended when we finally presented them with the actual numbers. That is very specific.

But the ultimate result, which is the important thing, is that you would have a vastly weaker national defense, and you would have accomplished for the Soviets what they can't accomplish in negotiations. You would have had unilateral reductions on our own part with no requirement that they make any reductions on theirs.

Mr. GRADISON. Mr. Secretary——

Mr. WEINBERGER. Now, we are being constantly told we don't give priorities. We have.

But what—we have given them right now and we have given them all the way through. But those priorities are priorities which should be kept, and when you make reductions in the ones that are slightly behind some of the others you adversely affect the entire national defense. Admiral Crowe can expand on that, too.

Mr. GRADISON. Mr. Secretary, I stand second to no one on the committee in terms of my concern on defense. I think my voting record bears this out. I am trying to be helpful. I don't think your response is.

I think unless we were able to get specifics to back up as I am sure they would, your general statement is going to make it harder for you to sell what you are trying to sell. That is your choice.

But I would urge you to reconsider and give us in writing a more specific statement . I have been in business, you have been in business, if I were sitting on a board of directors and the department

head came in and gave that kind of response I think as a director, and I am a director of some companies, and you have been too, you would say, can I have more specifics. That is all I am asking for.

Mr. WEINBERGER. We would ultimately have very specific results, Mr. Gradison. I think it is important that we would go back and ask the services what they would do with another reduction from $311 billion to $2—whatever your figures was.

Mr. GRADISON. $288 billion.

Mr. WEINBERGER. We would ask the services, given the President priorities, what they would cut out. I am giving you a preview of that.

They would say we would have to have fewer planes, we would have to have fewer ships, we would not be able to put in service ships that have been built and commissioned that we need. I could give you precise numbers and very specific numbers but I think it is more important that you have the overall picture, which is what I am doing today.

I am not going to go back and tell the services that they have to have 11 planes instead of 9 or 9 instead of 11, until I find out what their own priorities are. But their own priorities have been stated. Their own priorities have been drastically reduced to produce the budget that is before you. And we can certainly go back if Congress is so unwise as to make the kind of reductions you are talking about, we can certainly go back to them and tell them what additional amount of weakness they have to inject into the system.

I will be glad to furnish that to you.

Mr. GRADISON. I appreciate that and look forward to receiving it.

[The following information was supplied for the record:]

LOWER DEFENSE APPROPRIATIONS

The President's fiscal year 1987 budget request for the Department of Defense reflects the culmination of over a year's effort to review national security requirements, establish program levels necessary to counter challenges to those requirements, and to scrub the budget estimates for those programs. Every year, as I appear before various congressional committees I am asked for lists of programs I would propose to forego to achieve some arbitrarily derived funding level other than that contained in the President's budget. And, every year, I must reiterate that responding to such hypothetical inquiries is neither feasible nor constructive. To provide a correct and accurate response would entail an effort equal to that in developing the requirements reflected in the fiscal year 1987 budget as proposed. However, it is safe to say, that whenever the Congress provides fewer resources than those requested, there are significant implications for defense programs. This can be illustrated by the following table which identifies some of the programmatic effects that occurred when the Congress appropriated funding levels lower than those requested in the President's fiscal year 1986 budget request of February 1984.

ACTUAL APPROPRIATIONS VERSUS FEBRUARY 1984 BUDGET REQUEST

	Lost in fiscal year 1985	Lost in fiscal year 1986
Active military personnel:		
Navy/Marine	−5,200	−7,200
Air Forces	−8,100	−22,500
New ship construction:		
Total new ships	−1	−6
Aircraft:		
Total fighter/attack aircraft	−6	−66
F-14's		−6

ACTUAL APPROPRIATIONS VERSUS FEBRUARY 1984 BUDGET REQUEST—Continued

	Lost in fiscal year 1985	Lost in fiscal year 1986
F/A-18's		-18
F-15's	-6	-12
F-16's		-36
Reengined KC-135's	-10	-22
Combat vehicles:		
Bradley fighting vehicles	-55	-184
Missiles:		
Peacekeeper	-19	-36
Patriot	-145	-230
TOW 2 missiles	-6,000	-5,300
Standard missiles		-1,114
AIM-54C Phoenix missiles	-135	-302
AIM-120 AMRAAMS	-174	-1,027
AGM-65D IIR Mavericks	-1,900	-5,050
Major budget activity funding (billions):		
Operations and maintenance	-$2.7	-$19.4
Procurement	-$12.7	-$26.9
RDT&E	-$3.1	-$2.5
Military construction	-$1.7	-$4.4
Strategic defense initiative	-$.4	-$1.0

Mr. GRADISON. You said earlier in your testimony about the cutback in progress payments from 80 to 70 percent.

Mr. WEINBERGER. Ninety to eighty.

Mr. GRADISON. Excuse me, I beg your pardon, 10 percent, 90 to 80.

I have been talking to some of the defense contractors in my district about the impact of Gramm-Rudman-Hollings and the March 1 cuts, and frankly so far I have run into sort of a ho-hum attitude; in other words, they have not indicated that there have been any quantity reductions in what they are doing; they get paid, only later. It really doesn't slow things down.

Have there been any quantity—March 1 has not come yet—will, as of March 1, there be actual quantity reductions?

Mr. WEINBERGER. Of course, Mr. Gradison.

Mr. GRADISON. Could you give us a list of what those are?

Mr. WEINBERGER. Yes, I can give you some now.

Mr. GRADISON. That would be helpful. Thank you.

Mr. WEINBERGER. Of course, there have been reductions. You can't make this kind of a cut in defense plans without having very substantial reductions.

I can give you examples of a few things right now that we had to do before Gramm-Rudman. It is not in any sense anything that helps any of us.

We had to—we took out 17,000 personnel in the Navy and Marines, we dropped 22,500 people from the Air Force, we stopped construction on six new ships, we cut out 66 fighter aircraft.

We cut out 184 Bradley fighting vehicles; we cut out 5,300 TOW-2 missiles—I am running down the list, it goes on for a long time—we cut $19 billion out of operations and maintenance. We cut $4 billion out of military construction. Yes, we have been hurt badly by it.

Mr. GRADISON. Could we have copies of that, sir?

Mr. WEINBERGER. We will continue to be hurt by that.

Mr. GRADISON. Can we have copies of that, please?

Mr. WEINBERGER. Certainly.

Mr. GRADISON. Thank you.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from New York, Mr. Downey.

Mr. DOWNEY. Let me——

Mr. WEINBERGER. If I could complete that answer to Mr. Gradison, that is what was required before Gramm-Rudman. The sequestration begins in March.

Mr. GRADISON. Mr. Chairman, if I may, all I am asking is a list of what reductions you will be making beginning in March as a result of Gramm-Rudman-Hollings.

Mr. WEINBERGER. You will have that, too. It is in addition to the other.

Mr. GRADISON. Thank you.

[The following information was supplied for the record:]

DEPARTMENT OF DEFENSE SEQUESTRATION

The amounts sequestered from the National Defense Function for fiscal year 1986 pursuant to Public Law 99-177 were identified by program, project and activity in a joint report to the Comptroller General by the Director of the Congressional Budget Office (CBO) and the Director of the Office of Management and Budget (OMB). This report was printed in the Federal Register on January 15. The Comptroller General of the United States made several changes to the CBO and OMB Report. These changes were summarized in the General Accounting Office (GAO) Report to the President and the Congress on January 21, 1986 and printed in the Federal Register on that date.

The CHAIRMAN. The gentleman from New York, Mr. Downey.

Mr. DOWNEY. Thank you very much, Mr. Chairman.

First of all I want to offer my congratulations to Admiral Crowe. He has a remarkable few years ahead of him with Gramm-Rudman.

I will start off with a small accolade for you, Mr. Secretary. I don't want to overdo it, but your report is well written and the report provided therein is better than I have seen in the past.

Mr. WEINBERGER. Thank you.

Mr. DOWNEY. So much for the good news.

I want to say that you have been remarkably consistent. Since 1981 when we were behind the Russians we have needed to spend more. In 1985, 1986 we are still behind the Russians and need to spend more.

When they were not at the bargaining table we needed to spend to get them there; now that they are there, we need to spend to keep them there.

This administration has talked about how we can only make our country strong by spending more on defense and that makes us strong but spending money for everything else makes us weak.

It is a simply preposterous position to be in. The words of Roseanna Danna, Mr. Secretary, when it comes to spending there is always something for which we need to spend in your opinion.

Now, if we are to plan properly to avoid the Rocky Mountain highs of the early 1980's, and the Death Valley lows of potential Gramm-Rudman we are going to have to work together. Mr. Gradison told you that.

You will be the single largest and biggest, and most powerful instrument for the forcing of sequestration. I hope we avoid sequestration because I agree with you it would be a disaster for defense. But I know your method of operation over the last 5 years: To defend consistently your position, to say there is no compromise, to say that the priorities are such that everything that gets cut hurts us in all the same ways. This is going to force Congress to sequestration unless you change your method of operation.

You are going to have to tell us honestly and candidly whether you really believe that a 75-percent increase in the strategic defense initiative is as important as training our flyers to fly, teaching our tank gunners to shoot guns, to do all those things. Because if they are all priorities then none of them are priorities.

You also are going to have to stop perpetuating the myth that has been in every budget and has been talked about administration nauseaum, and I would hope dispensed with, and that is that the decade of the 1970's was a period of neglect.

During the decade of the 1970's with President Nixon and President Ford—President Ford especially gets irate when he hears this—we modernized every single aspect of our triad, we added 550 Minuteman III missiles, we increased by sixfold bomber-delivered submarine-launched ballistic missile warheads and increased by 40 percent the number of bomber weapons.

It was not a decade of neglect. Let's stop talking about fantasy and start talking reality.

This is a strong country, it has been made marginally more strong by the $1 trillion we have spent over the last years. But if we are to maintain some consistent strength we are going to have to plan together a lot less spending than what you sent us or we are going to trigger sequestration which we both feel is a disaster.

I am going to ask you specifically, and quickly, about the strategic defense initiative.

You talk constantly about the fact that people don't talk about the Soviet massive effort in defense. It is a massive effort in defense. It is a massive effort in defense like there is a massive effort in the Soviet Union for agriculture. A lot of people, a lot of money, very little output.

In terms of their offense, it is something they are very much worried about. As we begin to take a look at the strategic defense initiative there are remarkable estimates emanating from the administration and from those who are not in the administration about the effectiveness of the plan.

Last year, one of the members of your panel on Star Wars battle management software resigned. He made the following three charges.

First, that no member of the panel had had any experience designing battle management software.

Second, that no member of the panel had any experience with missile trajectories.

Third, that every member of the panel stood to profit financially from the continuation of SDI.

Are these charges correct, Mr. Secretary?

Mr. WEINBERGER. No.

Mr. DOWNEY. None of them?

Before the World Affairs Council in Philadelphia, one of your representatives said we can get Star Wars fielded for between $10 and $100 billion. Now your preliminary research requires that we spend about $26 billion. Will be able to get the rest of the program for $75 billion?

Mr. WEINBERGER. No; I don't think anybody really knows, because we have not finished the research program, Mr. Downey. We have a great deal of work to do on research.

We think it is imperative that we do it as quickly as we can, because we think the concept of a thoroughly reliable defense against incoming Soviet nuclear missiles holds out more hope for the world than any other concept that is being developed for at least the last 50 years.

So, we want to get on with the research, but nobody knows, first, whether we can do it or not and, second, how much it will cost.

Mr. DOWNEY. Can I ask you, if nobody knows how much it will cost, how you justify the estimates that you made that cannot conceive of the strategic defense costing more than, let me quote you: "can be more costly than the constant need to modernize and strenghthen as each side moves too much other sides have to make a response."

This is an estimate you made about the fact that you believe that SDI will cost us less.

Mr. WEINBERGER. It is very simple because once you get strategic defense, if you can get it, you have completed it.

You would have a thoroughly reliable defense. With offensive forces, you have to keep adding and modernizing or you should, and we had not modernized until the President took office and you have to keep doing that.

That is very expensive, but if you have a strategic defense that works that completes the cycle and you don't need to do the offensive modernization. So it is obviously going to be very much less expensive, if we can get strategic defense, than the continual program of very expensive offensive modernization.

Mr. DOWNEY. It is remarkable to me that we don't know what it costs but we can predict that it will cost less than something else once we have it.

Are you suggesting to us that once we have the strategic defense initiative in place that we are not going to have to upgrade it in any way to account for increased Soviet offensive behavior, that they won't improve it, modernize their own or——

Mr. WEINBERGER. That is why the research is expensive because what we want to get is a system that is not capable of being overwhelmed, that is thoroughly reliable and effective.

It will be costly to find that out by our research program. It will be infinitely more costly if the Soviets get that kind of a program, on which they have been working for 17 years, and we don't have it. It will be inifinitely less expensive than a continual upgrade of offensive weapons, which presently hold out no hope for the world except that of a mutual suicide pact.

Mr. DOWNEY. I am fascinated by your belief in technology that can do more for us than potential human understanding with arms control.

In the latest Challenger catastrophy— I realize there is much yet to be learned about what happened—are you in any way concerned that the technology that was available for Challenger is primitive by comparison to what we will need for a SDI, that it is possible that maybe technology is not going to give us this impenetrable barrier to protect us that we once thought? Have we learned anything from that disaster?

Mr. WEINBERGER. We have learned a great deal from that disaster and one of the things I have learned from it is not to use it for political purposes or political gain.

That was a terrible disaster, but it is not any reason whatsoever for saying that we should stop trying to get the most hopeful kinds of concept in strategic theory and strategic practice that this country or the world has seen for at least half a century. What the SDI will do if it can work, and the reason why it is so important to continue working at it is to give us a thoroughly reliable defense against the shadow and horror of nuclear weapons that have hung over the world since they were first developed.

Mr. DOWNEY. I am glad that you and the President Reagan continue to believe that that is possible to do because apparently, with very few exceptions, you are alone in believing that that is possible.

Let me ask a question about something that Mr. Gardner said. He is the SDI director of systems. He said that as defenses are introduced on both sides the net result of the exchange is fairly sharply in favor of the United States. His reasoning is that we will have a more powerful bomber force than the Soviets.

Somehow, of course, the Pentagon neglected to mention that when they were selling the B–1. What I find curious is the Soviet Union would not seek to mirror the U.S. range.

Why wouldn't a bomber technology that is availalbe to them today, why wouldn't they follow us, and build a lot more bombers and attempt to overwhelm, if there is ever a possibility of doing that, the SDI, which will be for ballistic missiles, and we will have to spend a great deal of money, will we not, if they follow our lead on air defense bombers?

Mr. WEINBERGER. One of the problems is it is not a matter of their mirroring us. They have done this. These are things there and deployed.

What we are trying to do with respect to strategic defense, first of all, is to put into place this very hopeful concept and, second, to make sure that the Soviets don't put it into place first, and then have a complete breakthrough and without our having even started on the very long path it will take to get it.

They have already developed very, very strong traditional standard defenses. They have already developed and are developing—and we have had the charts here to show you this morning—a very strong, new, modern bomber force.

So it is not a matter of their mirroring us. They start in on these things—and until we get some kind of a verifiable set of agreements that provide for real reductions and don't license increases, such as the SALT agreements did—we are going to have to spend much more money than any of us would like to make sure we have a deterrent capability.

Mr. DOWNEY. Thank you very much, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Secretary, I have a little chart here I would like to go over with you. I think you are familiar with what is involved; 72 percent of the budget is not subject to sequestration under Gramm-Rudman; 28 percent is. Of that 28 percent, 17 percent of that is in the defense budget. Of course, the remainder is in the domestic budget.

If we have a sequestration on October 1, that is if Congress can't pass a budget or if we pass a budget that significantly misses that target, we have done some estimates, done on what what the results would be and I am sure you are familiar with those estimates.

Let's say right now CBO's baseline is $178 billion. Of course the Gramm-Rudman figure is $144 billion, so the difference is $34 billion. If we had a $34 billion sequestration October 1, that portion of the defense budget, which is subject to sequestration, would take a 9-percent, across-the-board cut, 9 percent.

As you indicated in your earlier testimony there are no exemptions or exceptions for personnel. Personnel would take that 9 percent just like research elsewhere, every other part of your budget in 1987.

Obviously, we want to avoid that and you want to avoid that. That is why the statistics, that is why the figures are so important to this committee in terms of accuracy.

So, let me ask you a question. If we don't avoid this for whatever reason and if there is a 9-percent, across-the-board cut and that applies to personnel, how many people are you going to have to lay off, discharge, remove from the active duty service?

Mr. WEINBERGER. We have about 2.1 million in the active military and we would probably have to reduce about 200,000 right away, immediately.

At least 200,000, and we would have to do it right away. People who worry about the national security would worry greatly, and people who worry about the economy also ought to worry, because it would cause more Government expenditures elsewhere.

Mr. FROST. 200,000 would have to be removed October 1 from active duty?

Mr. WEINBERGER. 280,000 would have had to have been removed this March——

Mr. FROST. My question is October 1.

Mr. WEINBERGER. Let me finish, please. In March, 280,000 would have had to be removed if Gramm-Rudman had not had that personnel exemption for this one year. It doesn't have it next year. So we don't know exactly what it would be, but it would certainly be in that 250,000 range.

Mr. FROST. Mr. Secretary, of course the $34 billion figure is much higher than the $11.7 billion figure that the sequestration applies to in 1986.

Mr. WEINBERGER. That is right.

Mr. FROST. So let's talk about the $34 billion figure and a 9-percent, across-the-board cut in defense. If you had a 9-percent cut in your personnel function, how many people would be removed?

Mr. WEINBERGER. Probably somewhere close to twice the number that we would have had to remove this year, maybe a little less. But——

Mr. FROST. 160,000?

Mr. WEINBERGER. About 400,000, 380,000, 425,000, around in that range; yes.

Mr. FROST. More than 400,000 people would be removed?

Mr. WEINBERGER. Quite probably, yes.

Mr. FROST. Mr. Secretary, we are, as you are, looking for ways to avoid that happening.

Mr. WEINBERGER. Yes.

Mr. FROST. It has been suggested in some discussions by some Members of Congress, including the chairman of the Armed Services Committee, that when we look at the budget this year that we on this committee should follow the guidelines in Gramm-Rudman.

Now, Gramm-Rudman provides that half of the cuts come from defense and half from nondefense. The President approved—the President supported Gramm-Rudman, signed the bill, worked on its behalf.

Mr. Secretary, in drawing the 1987 budget, should we mirror Gramm-Rudman? Should we halve the cuts that we have to make come out of defense, and halve the cuts come out of nondefense? The President supported this concept for Gramm-Rudman. Why wouldn't this be equally applicable and appropriate for the 1987 budget?

Mr. WEINBERGER. Congressman, you are assuming some cuts have to be made in the President's budget and some changes made in it. What we are arguing for is that you accept it, because then you would avoid all that.

I don't think you help the situation any, which you correctly describe as disaster, if Gramm-Rudman sequestration comes into effect, by putting it into effect before it is required.

Mr. FROST. Mr. Secretary, if we were to start from current services, CBO current services, $178 billion deficit, and try to fashion an equitable and fair budget for this country getting down to $144 billion, what would be wrong in doing that with taking half out of defense and half out of nondefense? Or if you think that is unfair, what would be wrong with saying—doing one-third of that with additional revenues, one-third out of defense and one-third of the domestic budget?

What is wrong with this committee trying to go from current services' deficit of $178 billion down to $144 billion and following the basic framework of Gramm-Rudman, not as extreme, not in as large numbers, but following that basic structure the President supports?

Mr. WEINBERGER. I think you are wrong on it, Congressman. One point is that defense is not 50 percent; it is 27 percent of the budget. Another is, there are a great many more important functions for the Federal Government than others. I can't think of any more important function than defense since only the Federal Government can do it and since none of the other things you are talking about can survive without a strong defense and without national security.

I can think of a great many other ways in which reductions that you feel you have to make may have—should be made. But the right way is certainly not taking half out of defense and half out of anything else because of some perceived fairness, because that isn't even fair.

The defense portion is 27 percent. Why raise the reductions to 50 percent when you have already made sufficient cuts that you are now minus 6 percent for this year?

Mr. FROST. Mr. Chairman, I won't take more time because I know other members have questions. I would just like to conclude by observing that if it was fair for Gramm-Rudman, why is it not fair for the formal budgetary process for fiscal year 1987?

Mr. WEINBERGER. Gramm-Rudman.

Mr. FROST. I don't understand that, Mr. Chairman.

Mr. WEINBERGER. Gramm-Rudman is not supposed to be put into effect. It is designed to be avoided. That is the whole rationale for it—that it would create a situation so bad that theoretically Congress will avoid letting it happen.

Mr. FROST. But it is being put into effect for fiscal year 1986.

Mr. WEINBERGER. In 1986, without any option. Now we have an option in 1987 and we should exercise it.

Mr. FROST. Thank you, Mr. Chairman.

The CHAIRMAN. The time now goes to the gentleman from Texas, Mr. Boulter.

Mr. BOULTER. Mr. Secretary, I am certainly in agreement with you that the No. 1 priority of this Nation is our own defense. But from the standpoint of a prodefense conservative, we are all prodefense on this panel. I know you realize that. But I am a prodefense conservative.

I start, however, with the proposition that just throwing more money at the problem doesn't necessarily produce any better benefits in this area than it does in housing, or education, or welfare. And we have put a lot of money into defense since the Carter years. In fact, in terms of 1986 dollars, the defense budget has increased from the normal post-Korea peacetime levels of under $200 billion to almost $300 billion in 1986.

I am just interested in knowing what you believe we have actually gained in terms of defense output with this huge input of money. There have been three studies performed recently by the CBO, the Congressional Military Reform Caucus, and Chairman Aspin's committee. All of these three studies reach basically the same conclusion.

These studies show, as I understand them, readiness may be up a few percent or down a few percent, but it is roughly where it has been; force size shrunk slightly for strategic forces in the Air Force; and Navy may have grown a few percent; Navy ships, 13 percent. But that is due in large part to holding on to old ships.

Weapons systems have increased about 100 percent, and yet it seems that a lot of our forces are doing just the opposite of modernizing. We have aging weapons instead of weapons that are newer and newer.

So question 1, Mr. Secretary, is: What can we conclude from the assessments by these three different studies of defense output versus money input?

The second area I would like for you to comment on is the Department of Defense civilian manpower force. It seems that we have had a huge jobs creation expansion there without almost any of us knowing about it since 1981. We have had an increase of 138,000 civilian employees in DOD since that time, and there are well over 1 million civilian employees in DOD now. I think it is obvious that these numbers contribute significantly to our redtape problem, our paperwork buildups and delays, and our excessive specifications in research, development, and procurement areas.

I wonder if you would consider a civilian employment rollback to 1980 levels? My understanding is that that would save several billion dollars in the first year.

Mr. WEINBERGER. Well, of the two or three points that you made there, Mr. Boulter, first I would like to respond to your point about throwing money at a problem.

It doesn't seem to be generally realized that about half of the defense budget, a little less than half this year, goes to the military personnel costs, because we pay the kind of salaries that we should to the men and women who do these tasks for us. We do that and get them on a volunteer basis, and that is about, as I say, close to 50 percent of our budget.

In the Soviet Union, the figure is 9 percent. So we start with about half of our budget going to obtain and keep the people we need to do these tasks.

And what did we get for it? We got a very great deal. I went through all these charts, but I am delighted to go through them again.

We will have 54 Peacekeeper missiles, which we think strengthens our deterrent for the first time, giving us the kind of capability that we need to meet the 8 new systems deployed by the Soviets while we were debating for 11 years whether we should have the MX.

We have 518 Trident C-4 missiles now as against 100 that we had before.

We have six Trident submarines we didn't have before. Some of them were ordered in the 1970's, but the execution of the contracts was so poor and so expensive that we had none delivered, and they were 22 months late when we got here. We now have six on line, and the seventh will be there shortly.

We have funds authorized and appropriated for 100 B-1 bombers, and we have been talking about that program since 1970. I put it in the budget in 1971 when I was at OMB. It was canceled in 1977. We will have our 100 at the end of next year.

We will have 1,400 air-launched cruise missiles as opposed to 12.

We have 134 reengined KC-135 tankers as opposed to zero.

We have 130 Pershing II missiles deployed in Europe—as opposed to zero. They have been instrumental in a change of Soviet attitudes with respect to negotiations.

We have 196 ground-launched cruise missiles as opposed to zero in 1980.

We have 29 C-5B planes, the reengined, rewinged plane that is far more effective, either on hand or in the pipeline.

We will have 57 KC-10's in addition to 35 as opposed to zero in 1980.

We will have 75 ships in the Ready Reserve Force for sealift.

We will have 3,021 M-1 tanks as opposed to 34 in 1980.

We have nearly 2,000 Bradley fighting vehicles as opposed to zero.

We have 111 Hellfire missiles as opposed to zero. We will have 21,000 that are already funded that will be out of the pipeline shortly.

We have 990 Cobra helicopters as opposed to 530; 45 Apache helicopters as opposed to zero; 408 more in the pipeline.

We will have 6,554 Stingers as opposed to zero in 1980.

I don't know how much time I have, Mr. Chairman, but this list goes on for a very long time. The theory that you are not gaining anything because some study that was adversely motivated at the beginning says so, certainly doesn't seem to me to be a very sound basis for making defense policy.

As for the civilian increase, we have tried to do what the Congress repeatedly told us to do, which is absolutely correct, and that is to move military tasks to the military and not have them performing civilian tasks.

Just one of the reasons why we need to have an increase in civilian personnel is that last year alone the Congress required us to furnish, just last year now, 676 new reports, and you are, very properly, interested in getting them on time. We may be a day or two late with some of them, but we need people to do that.

I think it is much better to have civilian people work on those tasks, if somebody has to, than to divert trained military people from their military tasks.

Admiral CROWE. Could I inject a comment, please, Mr. Boulter?

The CHAIRMAN. Go ahead.

Admiral CROWE. Those studies you quoted, there is not a single military command in the country that agrees with those statements. The capability we have acquired from 1980 to 1985 has been substantial and material, clear across the board, and there isn't an operational commander in this country who won't tell you that. His capabilities increased from two to five times.

I have a lot of statistics and briefings and information on that. I would be happy to furnish that. But the thought our readiness has not increased markedly is dead wrong.

Mr. BOULTER. I thank you very much for that information. I really do. I accept that from you. Thank you, sir. Thank you, Mr. Secretary.

Admiral CROWE. Thank you.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Massachusetts, Mr. Atkins.

Mr. ATKINS. Thank you, Mr. Chairman.

Secretary Weinberger, in the Department of Defense budgets for fiscal years 1983 through 1986, the prices of major weapons systems were projected to increase at rates 30 percent greater than the Consumer Price Index.

The Department of Defense has apparently abandoned this practice in preparing the fiscal year 1987 budget request, and for that, Mr. Secretary, I congratulate you. However, in the outyear topline projection, the 5-year defense plan, you have not made similar revisions on the inflation projections for major weapons systems. By

my calculations, were you to make those projections, you would yield $26 to $30 billion in savings over that 5-year defense plan.

I am wondering, Mr. Secretary, why you have not done that, and do you plan to make those corrections?

Mr. WEINBERGER. We have brought down very substantially, as I said in the opening statement, the acquisition costs of the 84 major weapons systems. The cost increases now are running less than 1 percent a year in those major weapons systems. That is for 2 years running. That is as opposed to about a 14-percent annual increase over the years before we got here.

With respect to the inflation estimates generally throughout the entire budget—and it is not usually allocated against a specific item—the inflation estimates generally reflected in the defense budget are based on the inflation estimates that OMB has given us, which I understand are generally agreed to by the Congressional Budget Office and the General Accounting Office. It is around 3.7 percent for fiscal year 1987. That is a very low estimate of inflation.

But our estimates of inflation that have been agreed on in the past were too high, and then we are delighted they were. We would much rather be able to get more defense for less dollars and not have it go to cost increases. If the estimate is wrong for inflation, then we will not spend it for that purpose. We will either ask to have it reprogrammed so you won't have to expend as much in the future, or we will turn it back to the Treasury.

There is not an inflation estimate against specific items in the budget. The 84 weapons systems were covered both by general inflation estimates and by the special weapons inflator. That special weapons inflator this year is at zero.

Mr. ATKINS. If I might, Mr. Secretary, you have eliminated the special weapons inflator for this year. I congratulate you for that. It was a figure 30 percent higher than the CPI.

Mr. WEINBERGER. Yes.

Mr. ATKINS. My question is, If you eliminated it for this year, why have you not eliminated it for your outyear projections?

Mr. WEINBERGER. Because we don't want to have the kind of underestimate that results in what are always referred to as cost overruns.

The special weapons inflator, as I am sure you know, is based on the whole idea of the skilled labor required for that and scarce materials required by high technology items, which cost a great deal more.

This year, we found it did not. So we took it out. But for subsequent years, I think it is only proper to put it in. If indeed it is wrong, then we will certainly not spend it.

Mr. ATKINS. But the fact of the matter is that from 1983 through 1986 you didn't need it during that period of time, either, which left you——

Mr. WEINBERGER. We did not spend it.

Mr. ATKINS [continuing]. Which left you the $40 billion slush fund. If you didn't need it then, and you yourself say you don't need it for 1987, how can you possibly include it for the next 5 years?

Mr. WEINBERGER. You did need a good bit of it in 1983 to 1986, and we don't know what we will need in the outyears. We thought it only fair because one of our first precepts when we came in was that we should not underestimate costs when we came to the Congress. We should try to give you as realistic estimates as we could, and we have no reason to know whether or not those special factors that cause special increases in high technology major weapons systems will be in effect in future years or not.

We are very hopeful that they won't be in effect in 1987. It may very well become effective again. We don't know how we can keep inflation at the low rates we have.

Mr. ATKINS. You have created a situation where, on the one hand, you are saying you don't want to underestimate inflation; yet, on the other hand, you have underestimated outlays by $15 billion. And your response to that——

Mr. WEINBERGER. We don't acknowledge that at all.

Mr. ATKINS. I was listening to you earlier. You were saying that the historical relationship between budget authority and outlays has changed because of audits, an 80-percent payout on work in progress, and additional contract review and additional testing. All those amount not to lower costs but simply to delayed payments.

Mr. WEINBERGER. That is correct.

Mr. ATKINS. So what we have done is we have not reduced the basket of things that we are buying in defense. We have simply devised a number of mechanisms to delay paying those bills. Those bills will indeed come due. They will indeed add to the deficit. They will indeed cause sequestration at some point. I think that is a very, very dangerous kind of thing.

Mr. WEINBERGER. Mr. Atkins, some of those things we talked about will indeed result in lower costs. Some will result in lower payments, which is what we are talking about when we are talking about outlay estimates. But some of them will result in much lower costs because already our increased audit program has resulted in major savings.

We had it on the charts, and you can see it there. It is $8.1 billion. The internal audits are $2.7 billion.

Mr. ATKINS. You have already taken the projected savings from increased audits. That is separate from the outlay savings. The savings that you are getting in outlays from your audits are simply by the fact that you are delaying payment to the contractors.

Mr. WEINBERGER. A couple of things, Mr. Atkins.

Mr. ATKINS. What we are really doing is, having spent over the last 5 years $1 trillion on defense, using a credit card, we are now saying because times are tough we are still going to use the credit card, but we are just not going to make the payments to the credit company, the banks, in timely fashion.

Mr. WEINBERGER. You are talking about two different things. That $1 trillion is always used. In that same period of time, $2.7 trillion went in nondefense items. So we ought to keep that in proportion. I am talking about the time of payment.

When the chairman challenged the outlay estimates, I am talking about times of payment which are the things that determine outlays.

Mr. ATKINS. And all we are doing is we are simply delaying——

Mr. WEINBERGER. No.

Mr. ATKINS. We are not buying less. We are delaying the time we take to pay things.

Mr. WEINBERGER. We are buying a great deal more for less money because inflation has run a lot lower than has been the estimate, and we are delighted it has been. We think it is proper to put into the budget estimates for the outyears—we think it is proper to put in a warning that this inflation picture may not always last. But if we—when we come to the actual budget for those outyears that you recite, if we don't feel the inflation is going to be there—then we won't put it in, just as we did not do for 1987, the one before you——

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

Mr. Secretary, Admiral Crowe, it is good to see you today.

First, let me say that I think I share the view of the majority of the members of this committee that the No. 1 responsibility of the Federal Government is clearly defense of this country. And I commend you, Mr. Weinberger, for your dedicated, tireless efforts in pursuit of that objective.

Mr. WEINBERGER. Thank you.

Mr. SLATTERY. I would also point out that I believe strongly that there is a direct relationship between our national security and our national solvency. And I came across an interesting quote by a fellow Kansan, former President, and probably one of the greatest soldiers in our Nation's history, former President Eisenhower, and he observes that:

> We cannot mortgage the material assets of our grandchildren without risking the loss also of their political and spiritual heritage. We want democracy to survive for all generations to come, not to become the insolvent phantom of tomorrow.

That was General Eisenhower.

Since 1980—I don't dispute the fact that we have enhanced our Nation's defense capability, and I think this administration should receive some credit for that, and I believe that Congress, which appropriated the money necessary to achieve that goal, also deserves some credit.

I wasn't here in 1981 when some of those initial decisions were made, but I think we are moving in the right direction. Since that time, we have also doubled our Nation's debt, and that is something that is of great concern to me. And as a result of the doubling of our Nation's debt, those young Americans entering the workforce today will have to pay over their lifetime an estimated $50,000 in additional taxes just to cover the debt service on that portion of our Nation's debt that has been accumulated since 1981.

I think that is something that we should all keep in mind as we go through this mental exercise with regard to the question of whether we need any additional revenue this year to achieve the kind of political compromise that we need to resolve this budget dilemma.

As I observe our situation right now, I would make the point that I see two threats to the political consensus that is required in our democracy to maintain a strong national defense, and the first

threat is one that we saw last year, and it has subsided somewhat in the press today. That is, the series of horror stories about the tremendous waste, whether General Dynamics or whoever else it was that the public focused on last year and raised serious questions about the procurement procedures we were using and how badly that needed to be improved.

The second threat that I see—and this, Mr. Secretary, is where we need your help—the second threat to that political consensus is horrible, irresponsible fiscal policies that result in enormous deficits that result in the doubling of the Nation's debt that took us over 200 years to accummulate.

As a result of that horrible fiscal irresponsibiity, we saw a political document emerge called Gramm-Rudman, and that is a political response to an economic problem, really, and as a result now we face a real threat to the Pentagon, to the defense of this country.

It is the result of irresponsible fiscal policy. Now, there is a great debate taking place in the country today as to whether we need additional revenues or not. We hear continually from the President that to increase revenues would result in increased domestic spending, and therefore, we should not increase revenues of any kind.

He dug his heels in on that point. He makes the point we have dramatically increased spending over the last 15 or 20 years. No question about that; spending has increased.

He also makes the point that Social Security and Medicare do not contribute to the deficit. He is dead wrong on that point, but nonetheless, he takes that position.

And he suggests we should take Social Security and Medicare off the budget. I would like to show to you, Mr. Secretary—and these are not new figures, we have talked about this before—I would like to show to other people in the room and those people, perhaps, listening on television the real numbers when we look at the Federal budget deficit and what has happened since the early 1960's.

I will show this to members of the committee, also. If you do as the President has suggested, and that is to remove Social Security and Medicare from the budget, and if you remove also the revenues that are currently collected by payroll taxes to fund that portion of the budget which the President proposes to remove, let's look at what historically we would be looking at.

In the early 1960's, spending, excluding Social Security and Medicare, was 16.5 percent of gross national product. Spending on that part of the budget including defense has increased only nine-tenths of 1 percent of gross national product since before the Great Society, increasing today to 17.4 percent of gross national product.

Revenues, on the other hand, to fund that portion of the budget that is left after taking Social Security and Medicare off the budget, in early 1960's was approximately 16 percent of the gross national product.

Today, if we were to do as the President has suggested and remove Social Security and Medicare funding, the payroll taxes, in effect, from the budget, then revenues would decline to only 12.4 percent of gross national product.

Let me show this to my colleagues on the committee and to those who may be listening out there in TV-land, also.

I make this point, because in the process, of course, we see that the deficit to fund that part of the budget that is left after we would remove Social Security and Medicare and rely on only that revenue that is left would be 5 percent of gross national product.

So, we are really almost borrowing close to 30 percent of the money that we need to run this Government if we would do as the President has suggested.

Ladies and gentlemen, those are the stark facts. That is what I call mortgaging the future of this country. That is what I call failing to pay our bills in this generation. I think that is a message, Mr. Weinberger, that you need to take to the President as the Secretary of Defense, as someone who is deeply concerned about the defense of this country, and convince our President that we should pay our bills and that we shouldn't ask our children and our grandchildren to pay our bills for the budget that he would have us pursue, and that is my biggest point of contention with this President and with his budget this year.

I would point out that we are looking at a situation that is clearly a threat to the political consensus that is essential to the maintenance of a strong national defense in the country.

I know, Mr. Chairman, that my time is up, but let me make one last point.

In fairness to the question of defense spending, I think that we should note that in these figures, in early 1960's, we were spending approximately 9 percent of gross national product on defense. Today we are spending approximately 7 percent, a little less than 7 percent depending on whose figures you are looking at on defense.

But even taking that into consideration, you can still see that we would be looking at a deficit of more than 3 percent of gross national product to fund that part of the deficit that would be left.

So, I make this point to you, because this is, per se, evidence that we are not paying our bills, per se, evidence, irrefutable evidence, and I don't understand why, as Americans, we can't pay our bills.

My time is up, I know, Mr. Chairman.

The CHAIRMAN. The time of the gentleman——

Mr. WEINBERGER. Would there be any time for a short comment, Mr. Chairman?

The CHAIRMAN. Mr. Secretary, we would not deny you an opportunity to briefly respond to the gentleman from Kansas.

Mr. WEINBERGER. You are very courteous, as always, sir, and I appreciate it.

I would say there is irrefutable evidence that we are not paying our bills and that that was why, indeed, the debt is increasing.

I think the important point, however, is that the assumption there is that if we had more revenue we would probably be all right. The President has always felt if we had more revenue the expenditures would raise much more rapidly. Irrefutable proof of that is the fact that we did get 42 percent more revenue following the tax cut of the President—we think, because of the tax cut—42 percent more revenue came in during that 5-year period, but unfortunately a 61-percent expenditure increase took place.

That 61-percent increase in expenditure in that 5-year period, that more than matched the increased revenue we got. Less than a third of that expenditure was for defense.

On Mr. Slattery's very interesting figures, far less than a third of that increase in spending is defense. If you don't have a sound defense, if you don't have a strong country, then all the other programs are very much at peril. Thank you, sir.

The CHAIRMAN. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

I would like to say to my friend from Kansas, you must think we are speedreaders down here the way you flashed that chart down here and turned it back the other way.

But thank you, Mr. Secretary and Mr. Chairman.

I would like to first comment that in the past summer I had the opportunity to visit many of our troops and the morale is great.

Mr. WEINBERGER. It is.

Mr. LOWRY. To you, Mr. Secretary, Mr. Chairman, and everybody else, everybody involved in that, I think that we need to say to you that is a good job. The morale is great. I was very, very impressed with our front line up there and with these young people. That is good.

Mr. WEINBERGER. Thank you. They are very good.

Mr. LOWRY. That, of course, leads right back to the things you commented on and others have commented on all this morning which is, as you pointed out, Gramm-Rudman in 1987 takes away from you the flexibility that in 1986 alone you were able to utilize to protect manpower.

I think as we look at what would happen with that sequestering taking away that flexibility from you, we are all very concerned.

Again, having spoken to these young people—they are not all young people, but they are excellent armed services—but would be a great mistake.

To follow up on Mr. Gradison's question, Mr. Gradison used a number, $288 billion, which is $20 billion above what I think budget authority would be under Gramm-Rudman, but say it is $20 billion above. It is my opinion, it might be max what will be coming out with this budget, $288 billion.

So, I would like to ask you to go further in your response to Mr. Gradison's question of with the $288 billion, where would you make the cuts. What would be the reductions?

I would like to throw one specific into my question, and that is the 600-ship Navy. Does that make it within a $288 billion budget authority?

Mr. WEINBERGER. No, sir.

Mr. LOWRY. Specifically, in my home area, there is a home port proposed of $350 million in the State of Washington to be spent for a home port.

I just wonder, with $288 billion budget authority, whether a home port, whether it would make sense to prioritize spending $350 million on that, and if you would just carry it, to specifically try to reply to the question.

Mr. WEINBERGER. Mr. Lowry, I certainly will. I gave Mr. Gradison on overview of the impact by subject matter and by area, to the best of my knowledge.

He didn't seem to be satisfied until he got the precise number of bullets we would be short, but we can even go do that part.

But, yes, if you have that kind of reduction in budget authority for 1987, which vitally affects spending for the next 5 to 6 years, you are obviously going to not only give up a lot of the things I mentioned in broad terms, but you are going to have to look at every single thing in there. If it is Gramm-Rudman-forced reduction, as opposed to a committee-forced reduction, or congressional-forced reduction; you don't have a choice.

But if it is congressionally forced, you would have to look at just about everything, too. We would try to protect, as I said, the manpower to the extent we were allowed. We would try to protect the strategic defense initiative and strategic modernization.

You would have to ask yourself in protecting manpower whether it would be good to have people idle, not able to operate, or to use the ships we were no longer able to deliver to them.

So, you would have a tremendous disruption in the plans, but the short answer to your question on the home port is, I don't know. I haven't any idea. I would certainly think the Navy would probably propose a lot of delay since the ships themselves for which all of these things are planned, on which they are all based, wouldn't be able to be delivered.

You talk about a 600-ship Navy, which we hope to get in the early 1990's or perhaps by late 1989, but we couldn't do that within 5 or 6 years of that type of cut. It takes 5 or 6 years to build these, and when you reduce authority that much in 1 year, as you know, you to make all these adjustments in the actual spending.

We don't want to sign a contract that we have to cancel at enormous expense. So, we have to change the entire pattern of procurement.

When we say a devastating effect, that is exactly, unfortunately, what we mean. If you don't have a personnel exemption, the quickest way to get the required outlay savings under that kind of an authority cut is, unfortunately, to let these very good people go. It is very hard to get them back again, as we found out in the 1970's.

Mr. LOWRY. Admiral, would you care to comment on my question of whether a 600-ship Navy would make sense under this type of a budget authority and whether a home port would make sense under this type of authority?

Admiral CROWE. Mr. Congressman, I would reinforce in spades what the Secretary has said, and I frankly don't know about an individual base or home port. But I do know that to keep things in balance and the kind of force we would like to protect even though we would put the priority on personnel, we would not only be hit hard with that kind of hypothetical cut in personnel, we would be cutting back organizations, we would be cutting divisions, and ships, and air wings.

You are talking about dramatic stuff here.

Mr. LOWRY. It is dramatic, but I don't think anybody in this Congress thinks that is a hypothetical number.

I don't think anybody on either side of the aisle isn't looking strongly at it. Bill Gradison, who correctly says he has a record for a strong defense, as anybody on this committee, he used that number. I think that is the high number. So, with the $288 billion budget authority, should we have a 600-ship Navy?

Admiral CROWE. Well, we would have to look at exactly what you are talking about, but it would have to be in a balanced fashion.

Mr. WEINBERGER. We know we need that, Mr. Lowry. We also know that we can delay dangerously long acquiring the strength we need. We do not know how much time we might be given next time.

We barely had enough time in World War II to do the things necessary to get ready to win it. We don't know how much time we would be given in any future aggression or attack.

So, that there are a lot of problematicals in these. My responsiblity, which I try to fulfill, is to tell you, the Congress, and the people, what it is we think we need when we need it, and that obviously has to be within available resources. We obviously think the United States can easily afford the kind of defense it needs, and the kind of defense that it needs, we think, is represented at the minimum in the figures we have submitted to you.

I have been up here all of a day and everybody is asking, can they be cut, and they may well be cut if that is what the Congress wants to do. But we don't think it is a wise thing to do, and we feel a responsibility to tell you why we think it is a very unwise thing to do.

Mr. LOWRY. Mr. Secretary, as I understand your response to Mr. Gradison and to me also, you indicated you would be able to give more specifics in writing.

Mr. WEINBERGER. Oh, yes.

Mr. LOWRY. Which would be hard to do now, but more specifics in writing.

Mr. WEINBERGER. I submit that we have given quite a detailed response to questions like that today. We have told you some of the things we acquired over the years, and we can certainly tell you some of the things we still need that we will not be able to get, and I will try to get it down to the last round of ammunition.

Mr. LOWRY. Thank you, Mr. Secretary.

The CHAIRMAN. The time of the gentleman has expired. The Chair recognizes the gentleman from Texas, Mr. Boulter.

Mr. BOULTER. Mr. Secretary, I want to come back to the question I asked earlier about civilian personnel in the Department of Defense. When I recited the figures of the rapid expansion there—over 1 million people in civilian employment now in DOD—you said they were needed to do all these reports that Congress requires. Yet most of these reports, but not nearly all, were required by the 1986 authorization and appropriations bills.

You also said that you have been shifting civilian functions out of the military into the civilian. And yet, while I didn't ask you about rollback in uniformed officers, we all know that today with the 2 million uniformed armed services we have more colonels, admirals, and generals than we had in 1945 when we had a 12 million uniformed armed services.

We do know that civilian defense employment has grown by 150,000 since 1981, so I want to repose the question to you. What are all these people doing? Are they contributing to overdesign specifications in resource and development and procurement? Do we have to employ all these civilians? What can you honestly say

about an attempt, which I suggest be made, to cut back on civilian employment in the Department of Defense?

Mr. WEINBERGER. We have made reductions at the direction of the Congress and the Office of Secretary. I think there have been two or three of these reductions in the last 3 years. What the people are doing. In addition to all of the reports I mentioned that you require are a number of functions that are required when the activities of the Defense Department are increased as they have been by the Congress. You can't have a much more active defense without having more people. You can't buy a lot of ships and not have them manned.

You can't buy a lot of tanks and not have people to deal with them. You have to repair them and maintain them. The other thing needed where there has been a big increase, a very large increase, has been in audit and internal investigation of the Inspector General.

All of these have increased very quickly because we recognized, on the basis of the initial audits we did that we had a great deal to correct in the contracting field, in the procurement field, and all the rest. We have also put, as I say, a lot of things in civilian hands that formerly had to be handled by the military but were not military tasks. The officer ratio to enlisted, I think, is about the proper one with respect to the size of the force we have now.

I would be glad to have Admiral Crowe comment on that because he knows more about that than any of us. I don't think there has been any excessive increase in employment that does not reflect the very needed, and welcome, required increases in activities.

Admiral CROWE. Would you like me to comment on the observation?

Mr. BOULTER. Yes, Admiral, please.

Admiral CROWE. Of course, it is true, and I have heard cited many times what you say in regard to the ratios as compared with those of World War II when we were in combat. But there has been a great deal of change in the character of our services over the years that has torqued this system and made it seem a little out of whack in peacetime.

To begin with, the Secretary mentioned technology. We are now having to work much more in the middle grade or upper grade in technology. Incidentally, that same characteristic has been reflected in industry where the ratios that we used to see are now going into middle management in larger numbers—the military has been affected by that as well.

The middle management also provides the very support that we need, as I have learned in the last week or 2 weeks, to do this level of participation in the budget hearings. You know, we are probably the only military in the world—that is probably an exaggeration, but we are certainly one of the few—that spends 12 months a year on our budget and we literally do.

This has required a lot of high-level help in Washington, in staff jobs to support this. Over and above that, we are now engaged in a lot of joint business, which the Joint Staff and OSD have had imposed on them.

We are now engaged, which we were not previously, in an elaborate group of alliance structures around the world where the

United States gives leadership; I am talking about NATO. We have an elaborate security assistance arrangement there and in the Far East, all of which has required more general and flag officers.

I really think we can defend this very well given the circumstances and the leadership which the United States provides.

Mr. BOULTER. Thank you, Admiral.

The CHAIRMAN. Thank you, Mr. Boulter, and Mr. Secretary. Since we have been preoccupied with Gramm-Rudman, I thought that you might like to know, Mr. Secretary, particularly because of your intense interest in the subject that the district court has ruled that the GAO is unconstitutional under Gramm-Rudman and thus the fallback procedures are valid and the February 1 order invalid. I just thought you might like to know that.

Mr. WEINBERGER. Will you excuse me while I get back to the Pentagon and make some adjustments?

The CHAIRMAN. Of course. However, I want to advise you that the Supreme Court will still have to rule because I am sure that there will be further appeals, but at least I thought you ought to know that, and you might have to revise your testimony about the 6 percent and the 4 percent.

Mr. WEINBERGER. No; unless you are going to restore that, that is pretty well gone, but maybe you will restore it because you wouldn't want to participate in unconstitutional actions.

The CHAIRMAN. Definitely; that is why I voted against it because I knew it was unconstitutional. This old preacher knows those things.

Mr. FAZIO. Mr. Chairman.

The CHAIRMAN. Mr. Fazio, I will yield to you for a moment.

Mr. FAZIO. As one of the 12 litigants, I might indicate my satisfaction with the result, but I think it is important to point out to everyone that the language that was required by the Senators in the Gramm-Rudman Act itself means that this does not in any way stay the effectiveness of the law. Further, it was anticipated that either side would appeal and, therefore, we have to continue to operate on the assumption that will be affirmed by the Supreme Court.

And I think everybody making political assessments of the course would have to say that while this is a step in the right direction, the U.S. Supreme Court will be a much tougher audience for the arguments that have prevailed at the appellate level.

The CHAIRMAN. Thank you, Mr. Fazio, for that clarification. So, in other words, the Secretary should not run back to the Pentagon right away. There has to be another ruling.

Mr. WEINBERGER. I will wait until this evening before spending it, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia, Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman. I appreciate that entree before my appearance here today.

Mr. Secretary, Admiral, I am delighted that you are here. I appreciate your testimony very much.

I do think it is probably incumbent upon the Congress and the President to disarm from a rhetoric standpoint, that we attempt to work out the differences as best we can, establish a treaty. Of

course, most of us believe in a verifiable treaty as we try to work out a budget resolution.

In order for me to feel comfortable and for members of this committee to feel comfortable, we must know that the facts presented to us are accurate. You will have more problems with many Members in the other side of the aisle and from the more conservative Democrats than you will have with other Members.

I give you that in the very beginning of my questions. Serving on the Ways and Means Committee, I am somewhat more knowledgeable of the revenue side of the budget than I am of the spending side. So I want to ask you where your revenue figures come from.

You indicated to the committee that revenues haven't really deteriorated. In fact, there has been a 42-percent increase in revenues, and I can only assume that what you are doing is looking at the total revenues for 1980 and comparing it with 1985. This gives you $734 billion in revenues, or a 42-percent increase. Is that correct?

Mr. WEINBERGER. Yes, sir; these are right out of the budget and the Treasury. The revenue in 1980 total was $517 billion. The deficit was $74 billion. In 1985, the revenues were $734 billion and the deficit was——

Mr. JENKINS. Fine; that is what I wanted. I wanted to make sure we were using the same baseline.

Mr. WEINBERGER. Yes, sir.

Mr. JENKINS. Now, I want to pursue that a bit. First of all, the tax bill that we are talking about that was enacted in 1981, became effective in 1982.

Mr. WEINBERGER. Right.

Mr. JENKINS. You are using a baseline of 1980 for revenues?

Mr. WEINBERGER. Yes.

Mr. JENKINS. I understand very clearly what you have done. Now, let's look at revenues other than payroll taxes, because of the $234 billion increase you are talking about, $110 billion of it increases Social Security taxes.

Mr. WEINBERGER. It is part of the revenue of the country. It reflects the buoyancy that the tax cut gave. Your payrolls have gone up, so your payroll taxes have gone up.

Mr. JENKINS. Does the administration take credit for the $110 billion increase in Social Security taxes?

Mr. WEINBERGER. The total revenue of the country has gone up at the time after a tax cut went into effect.

Mr. JENKINS. Yes; 1985——

Mr. WEINBERGER. It is actually across the board. The income taxes, the corporate income taxes, they have all gone up because there has been a substantial increase in the economy.

Mr. JENKINS. That is the point I want to make. Taxes have not all gone up in your baseline. Corporate taxes in 1980 were $64 billion. In 1985, they were $61 billion, a $3 billion decrease. Is that accurate?

Mr. WEINBERGER. I don't have that one, Mr. Jenkins, but I was told that revenues had generally gone up by the 42-percent figure, a total of $217 billion. Some of that is certainly in payroll tax, but by no means all of it, and my understanding is that there is a spread of that increase pretty well across the board.

Mr. JENKINS. That is inaccurate and that is why we really need to get the figures right. I am using the same tables you are, 1980 corporate taxes, $64.6 billion; 1985 corporate taxes, $61.3 billion. Those are the true figures. The 42 percent that you are talking about is made up primarily of Social Security payroll taxes.

We simply have not had any increase in revenues during this period of time because the growth has not yet started. I hope it starts soon.

Mr. WEINBERGER. Payroll tax increases are certainly an indication of growth, Mr. Jenkins.

Mr. JENKINS. Why isn't that reflected in corporate taxes?

Mr. WEINBERGER. It is reflected in the corporate tax. It is reflected in the personal income tax. It is reflected in all of the other sources of revenue of the Government.

I don't have your figures on the actual breakdown of corporate tax. I am perfectly willing to accept them, but I don't think that that vitiates the point that a tax cut does not necessarily bring about a reduction in revenue. In this case, it brought about an increase in revenue.

Mr. JENKINS. It brought about a decrease in corporate taxes.

Mr. WEINBERGER. As I say, I don't have those before me, but assuming that you have stated the facts correctly, it is a very small decrease or about a level number in corporate tax. The important thing to my mind, since we have to deal in these macronumbers, is the total and the total is up 42 percent.

Mr. JENKINS. I could talk about this particular area at great length. I might also add that $60 billion of that increase was windfall profits tax on oil. That makes $110 billion in payroll taxes and $63 billion windfall oil taxes. So we have taken up most of the increase in revenues with these two items.

Apparently we have had no growth or else the tax revenues have been reduced substantially.

Mr. WEINBERGER. I think every index anybody examined would tell you there has been an enormous growth in the economy in the past few years and it is a very fortunate thing for us. It has also been a growth without inflation.

Mr. JENKINS. I didn't want the committee to believe the misapprehension that there had been a 40-plus percent increase in business and personal taxes since 1980. I know my time is very limited.

Mr. WEINBERGER. Personal taxes. We said an overall increase of $217 billion, or 42 percent. I think that is a very satisfactory result.

Mr. JENKINS. We agree made up primarily of windfall taxes and Social Security taxes.

Now, on the spending side—and I have supported, and I intend to continue to support with some qualifications most of the defense effort. But you have real problems before this Congress that we had better sit down and try to work out. You will have as many problems on the other side of the aisle as you will from the Democratic side, believe me. Let's look at the same period of time since 1980 to 1986.

National defense, 79.2 percent increase, $124 billion increase; foreign aid, international affairs, next largest number, 42 percent increase. I am talking about outlays, dollars spent. Now, let's look at

other areas of the budget and show you the concern of the people and the Congress.

During that same period of time you have had an 11.8-percent decrease, actual decrease—we are not talking about inflation—in dollars spent in natural resources and the environment. You have had a 73-percent decrease in energy. You have had an 82-percent decrease in commerce and housing. You have had a static figure in transportation during that 5-year period of time, no increase. Community and regional development, a $4.1 billion decrease, a 38.7-percent actual decrease in dollars spent.

Education in this Nation during the same period of time, an actual decrease of 18.7 percent. I can go on and on and on. The increases that we have had and the reason we have problems is in large part because of the large increases in defense. Interest payments are also up substantially, attributable somewhat to defense, and Social Security is up, which is paid for by this $110 billion that I just mentioned.

We have deep problems. We need to come together to see if we can work this out. Otherwise you may very well end up with Gramm-Rudman, which incidentally would give you $10 billion less than what Congressman Dellums' proposal last year would have given you.

Thank you, Mr. Chairman.

Mr. WEINBERGER. Do I have any time to comment on that, Mr. Chairman?

The CHAIRMAN. Of course. I am going to give you an opportunity to respond.

Mr. WEINBERGER. Thank you. You are courteous, as always, and I do appreciate it. The figures that we were talking about suddenly shifted from dollars to percentages. There have been some substantial increase in dollars, which is the important thing in the defense as well as the nondefense accounts of the Government. The defense increased during that period by $118 billion, and it had to because it started from a very, very low base. Nondefense, all other, increased $236 billion.

So the expenditures total of the Government went up $355 billion when the revenues were going up $217 billion. And that, of course, is the story of the deficit. One-third of that increase in expenditures, a little less than that, was defense. We have had a lot of figures about the Federal total less Social Security and less interest and here again the pattern is the same.

The national defense expenditures have indeed gone up and they should have. We are grateful to the Congress for recognizing how important it was that they go up, but in every case you have either a 3 to 1 or a 2½ to 1 ratio between the defense increases and all other accounts.

So that you simply can't escape the fact, Mr. Chairman, that we are running well under a third. We are running about 27 percent of the total budget and we have right along and it is important, indeed, that defense go up. The problem is that it was perhaps not so important that all those other things go up too, but it certainly was vital that defense go up. That accounts for this kind of continued increase in the deficit even though we have had a very substantial increase in the revenue itself. I appreciate that.

Mr. JENKINS. Mr. Secretary, I appreciate your response and I know my time is up, but I also have the dollar figures of what you are including in the all other category. The reason for the distortion and the misapprehension on the part of a lot of committee members, is that the all other category includes interest and Social Security.

Mr. WEINBERGER. Mr. Jenkins, I have the figures without that—the outlays without Social Security and without net interest. The national defense went up $67.4 billion between 1982 to 1985. All other without those two accounts that you want to take out went up $56.2 billion. Therefore, excluding net interest and Social Security, the increases in defense spending were slightly higher than nondefense.

Mr. JENKINS. Well, we are using different years, but I have the 1981 figures because I started with the revenues in 1981. We keep switching to another year. I will read this column in dollar increases or decreases: 1981 to 1987, which this budget currently proposes. Defense dollar increase, $124.7 billion; international affairs, $5.5 billion. These are increases over the 5-year period.

General science, space and technology, $2.7 billion; energy, a reduction, $11.2 billion; natural resources, a reduction, actual reduction, $1.6 billion; agriculture, increase, $8.2 billion; commerce and housing, decrease $6.8 billion; community and regional development, decrease $4.1 billion; education, training, employment and social services, decrease, $6.3 billion; health, increase $8.1 billion; Medicare, increase $31.1 billion; income security, increase $18.7 billion; Social Security, increase $72.6 billion.

Now, the veterans benefits increase only $3.4 billion, administration of justice, increase $2.1 billion; general government, increase $1.5 billion; general purpose assistance, revenue sharing decrease $5.2 billion; net interest increase $79.3 billion.

I say to you that if you take out Social Security and Medicare and interest, then defense obviously has most of the increase.

Mr. WEINBERGER. Defense has increased, of course, Mr. Jenkins, but if you take out Social Security and net interest, nondefense spending decreased by $56.2 billion from fiscal year 1982 to fiscal year 1985 and national defense increased by $67.4 billion.

I don't see any problem with the figures you have cited. All of those other functions have increased. Some few have decreased, but the fact is we have not reined in the nondefense spending in a way that would have left us with a needed increase in defense without increasing the deficit. We could have done that.

Mr. JENKINS. Where, in Social Security?

Mr. WEINBERGER. With any of those numbers we have been citing, but we have been excluding Social Security and net interest for most of these sums we have talked about.

Mr. JENKINS. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman from Georgia has expired. The gentlewoman from California, Mrs. Boxer.

Mrs. BOXER. Thank you, Mr. Chairman. Let me welcome both of you gentlemen.

You know, Mr. Chairman, I think it would be important for us for a moment to look at a document that we all revere called the Constitution. We hear a lot of comments about what the function is

of Government, what the role is, what the proper role is, what is the most important thing for Government to do and I think we should go back to the roots of our democracy.

This is what it says:

> We, the people of the United States, in order to form a more perfect union, establish justice, ensure domestic tranquillity, provide for the common defense, promote the general welfare and secure the blessings of liberty***

And then we set up our Government. Mr. Chairman, it does not say in the Constitution that we provide for the common defense or promote the general welfare. It does not say we provide for the common defense and if we have a few dollars left over we promote the general welfare.

It says that we have to do both and I think the importance of Mr. Jenkins' recitation of what has happened over the past 5 years is very instructive and important. Now, I have got the numbers in a very quick fashion.

You have heard them a lot today, but I think they are relevant to what this country is about and what this Government is supposed to be about. Defense budget authority was $146 billion in fiscal year 1980 as the chairman pointed out in his opening comments.

In fiscal year 1987, if we go to the $320 billion request for budget authority that is a nominal increase of 119 percent over that period. Now, if you factor in inflation, it drops to a 56-percent real growth. Meanwhile, in the domestic side if you take out Social Security and Medicare and the entitlements, which we really have had built into the budget, and you look at the rest, what we see is a nominal 17-percent decline in those periods or if you factor in inflation, it is a 41-percent real decrease in those programs.

So you have a 56-percent increase versus a 41-percent decrease and I relate that very much to the Constitution and to back up Mr. Jenkins' point and we come from different parts of the country, as to why there is a little bit of unrest among the Members of Congress on both sides of aisle and I think, frankly, among the American people.

Mr. Chairman, I may not have time for a response. I hope you will give the Secretary time because there was something in his written testimony which he did not read and I read it carefully on pages 19 and 20 that I feel is something that I must bring up. In those pages of his written testimony, the Secretary chastises Members of Congress who he says are scrambling to publicize instances of waste which have frequently been corrected by the Department's own audit system.

The Secretary goes on to say that these actions by Members of Congress have hurt morale. Now, I just want to say on the record since this is given out to the press, this statement, I couldn't disagree with it more. I think that Members of Congress who are trying to find out in these very difficult times how to save money and still have a strong defense deserve to have praises for the efforts in which they have been engaged.

I would like to state that if it was not for John Dingell, the chairman of Energy and Commerce, we never would have heard about the greed on the part of one particular defense contractor who has

charged our taxpayers for country club memberships, for kenneling his dog and I might say that that incident that Mr. Dingell exposed led us to pass the allowable cost bill which the administration opposed but we got it through anyway by some incredible negotiating.

If it was not for a Member of Congress like Berkley Bedell, we wouldn't have found out about the $400 hammer which in itself isn't a whole issue. The issue is competition or lack thereof in our spare parts which led us to other legislation signed by the President to increase spare parts competition.

The real heroes in all of this—and there are other Members of Congress who have been very involved in this—are the whistleblowers, the whistleblowers who come to us when they are from the military or they are civilians and they say Congresswoman, Congressman, we need your support and help because we are getting harassed because we saw somebody throwing out thousands of dollars of unused spare parts and we saw greed on the part of the defense contractors and we saw the revolving door working in such a way that people who supervise the contract one day were employed by the defense contractor the next day.

In closing, let me say this. We have just seen the tip of the iceberg, Mr. Secretary, and what really saddens me is that we have had no cooperation from you and from the Pentagon as we seek to find ways to save money. It is 25 years to this date practically since President Eisenhower said his farewell address.

I am going to read briefly and close on this.

> In the councils of governments we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex. The potential for the disastrous rise of misplaced power exists and will persist.

I would say to you that this budget in my opinion, looking at this lack of balance, is in my opinion something that we should take a very close look at because I think it is General Eisenhower's worst nightmare starting to come true, and also since he warned us to stand up and be counted, I would like to not see you chastise Members of Congress. You can disagree with them, but I think it is our role to stand up and be heard on these issues.

Thank you, Mr. Chairman.

Mr. WEINBERGER. I would like to comment on that. We hear a great deal about chastisement. I take it the role of the Pentagon is to let everybody beat us about the head and not say anything so the public won't have facts before them.

Mrs. Boxer cited a lot of percentage growths which are really not a very clear indication of what the facts are. Your percentage growth in defense is going to be high when you start from a dangerously low base that could encourage the Soviets to think that they could with impunity attack us if we kept going on that path. The important thing is not the percentage of real growth for defense and the percentage of real growth or decrease in nondefense programs. The important things are what was spent and what was authorized.

During the period we are talking about, from 1982 to 1985 defense was authorized a total of $1.02 trillion. All other was authorized $2.7 trillion. That is almost 3 to 1. If the defense has gone up, as indeed it had to do, and if some of the others have gone down, as

indeed they should have years ago, then we still have almost a 3 to 1 ratio in favor of nondefense programs. It is important, I think, to bear those proportions in mind. When you start from a very low base, of course, your percentage increase is going to be high. The relevant factor is what do you end up with.

Now, on the other points that Mrs. Boxer raised, the important point I think to bear in mind is that we did indeed find the great bulk, if not virtually all, of these so-called problems in procurement. They are really problems, and we found them, and we corrected them. We found them because we put into effect the largest audits in the Department's history, and we furnished a lot of auditors to Congressmen and congressional committees individually. When these findings were available they were then publicized and picked up eagerly by others as a means of attacking defense, and we were presumably, of course, supposed to sit still and not say anything.

The fact is, we did find them. The fact is that we did take the steps necessary to correct them. We had situations in which attempts were made to charge outrageous prices for pliers and hammers and things of that kind, and we refused to pay them. Some of the contracts, Mr. Chairman, that we inherited were so bad we were not entitled to refunds. We did get the refunds anyway, and we changed a lot of the conditions that are there.

Things have been said about whistleblowers. Whistleblowers are specifically protected under regulations that I imposed on the Department soon after we came, because we wanted to know all of these things that anybody found that were wrong and change them. We also put in a hotline in which people could call anonymously if they wished. We received thousands of calls, and about 10 or 12 percent of those turned out to be quite useful. We pursue them and take the savings that are made.

So when you say there is no cooperation with the Pentagon, it is all right if you aren't interested in the facts. The fact is that we furnished the auditors to the committees. We told what we had found and we told the steps that we had taken to correct it. This kind of picking away at things that we found to use as evidence that Defense Department management is not good, not only flies in the face of the facts but it also causes injury to the Nation's security.

We don't want to pay a nickel more than we have to, and we don't. When we find things wrong we tell about it, and we stop it, just as we stopped a lot of nonsense about some of the costs that were being put in for reimbursement by some contractors. We refused all of those, and that is how they became known. When we refused them, then somehow it was reported as if they were all our fault.

The President has had a very neat way of phrasing this when he talked to me. He said if you keep on hunting for skeletons in the closet, somebody will indict you for murder, because they will think that you have done it all. That is not the case. We have found and reported them to the Congress, and they have then been reported as some brandnew discovery. We have exactly the same interests, Mr. Chairman, as anyone—perhaps greater—in making sure that these unacceptable practices and outrageous costs that

are attempted to be charged aren't realized. We have done that, and we will continue to do it.

Mrs. BOXER. Mr. Chairman, I would like to have 30 seconds.

Mr. LOWRY [presiding]. Very quickly, and we will move on.

Mrs. BOXER. I am very glad you say you want to go out after this waste and inefficiency, and I guess that lies in the eye of the beholder. But if you talk to the congressional people here, they have a totally different perspective. I personally knew a whistleblower who came to me and after revealing some outrageous price scandal, was then placed under constant surveillance and it was only because of the interest of Congress we knew, because we brought him before a committee and that was stopped.

All my plea is to you, and I won't go into the recent things that Mr. Dingell is looking at—the unpriced orders he calls a license to steal. You made a prior allusion to that. I think we have a long way to go. I would like to work together with you, Mr. Secretary.

Mr. WEINBERGER. I would, too, but you are assuming that things are wrong.

Mrs. BOXER. I would like to work with you instead of having this constant battle. We had so many good reform measures throughout the House that passed overwhelmingly only to get squashed in the Senate because the Pentagon and this administration didn't see fit to support us. We want to work with you because I think that is how you have a strong defense, by making sure you get the best bang for the buck.

Mr. WEINBERGER. Unpriced orders are not a license to steal; they are a method of getting things that you need before the long process of full negotiation of the contract is complete. But they are all within a ceiling so that they do not result in any higher cost ultimately. They are not a good practice, but they are a practice you have to use when you have an emergency situation and you need parts or specific items before you have time to negotiate a contract that protects the Government.

Mrs. BOXER. But you have $28 billion in unpriced orders.

Mr. WEINBERGER. You do not lose a nickel by them because they are all executed within a ceiling.

Mr. LOWRY. Thank you. Mr. Fazio.

Mr. FAZIO. Mr. Weinberger, you can relax now. We are not going to discuss the really tough defense question of the week, and that is to define "throwing." Andrea Mitchell has made it possible for us all to understand it now.

I would like to to concentrate my line of questioning on Admiral Crowe, and I want to welcome him here. I think his selection was a very popular one with people all across the spectrum. I happened to have had a chance to visit him in his Pacific Command Headquarters last year and I noted he had a very extensive hat collection. I am hoping among them is perhaps a green eyeshade, because I am afraid that is going to the the hallmark of your tenure as head of the Joint Chiefs of Staff.

I would like to ask you, in your capacity as a military professional, as you described yourself, to help us deal with the question of priorities in a way that perhaps it is impossible to expect the Secretary of Defense to do it. Regardless of whether we are going to have a law in effect in the fall mandating cuts with a hammer as

its current version of Gramm-Rudman would have it, I think we all know we are facing cuts in the defense budget this year.

Your visit to the Senate yesterday resulted in headlines like, "Senator Andrews Calls For Decapitation." Senator Domenici, who is certainly a friend of the administration, said that the administration was attempting to pay for defense with domestic spending cuts and that has no chance of passage in this Congress.

I think the Republican questions that came today indicate that there is some bipartisan consensus emerging that we are not going to have a $31 billion increase, as CBO would have your increase, and we are not going to have a $15 billion increase, as you would have it. We probably will not even have a freeze without some revenues. Certainly if we have any kind of overoptimistic growth estimates of GNP, which is not unusual, we could be facing another $20 billion of cuts to come up with.

For example, if we were to have a 3-percent real growth and not 4 percent in GNP, we could be facing—because Congress is not going to be, I think, willing to willy-nilly ignore the $144 billion target that Gramm-Rudman imposes on us, whether it is mandated or whether we impose it by a joint committee with the Senate—cuts as deep as $20 to $30 billion.

That has never confronted this administration before and it has never confronted this Congress. I therefore have to ask you again, as you are a self-described appellation "military professional," are we going to, for example, not proceed on an SSN-21, a new fast attack submarine? Are we not going to go forward with something the Air Force has been asking for for years, the C-17 cargo plane? Are we not going to go forward with the advanced technology bomber? Are we not going to go forward with Midgetman that most people in Congress have concluded is the most responsible land-based triad modernization we could come up with?

At the same time are we going to see SDI proceed at a very rapid rate? For example, in 1984, we spent $50 million on SDI. In 1985, we had a 2,900-percent increase to $1.4 billion. That comes as close as anything possibly could to meeting the description of throwing money at a problem. We had a 100-percent increase in SDI to $2.8 billion in 1986 and this year the administration talks about a 75-percent increase. The President kept it out of the 1986 Gramm-Rudman sequestration, fully funding it. Are we going to have cutbacks in your strategic modernization program, our conventional forces structure, to proceed the pace with SDI which, is at best, an illusion and I think, at worst, a strategic error?

Would you tell me, as a professional military man, whether you can countenance reductions in our capability at the same time we see these priorities implemented?

Admiral CROWE. Well, Congressman, I can't give you the answer to the questions specifically. You asked me are we going to cut system A as opposed to system B. Until I know what kind of situation we are dealing with, and when it comes to the Secretary of Defense he will ask the military to go through the same rigorous analysis that we have done in putting the budget together already.

Mr. FAZIO. The analysis is going to get a lot more rigorous?

Admiral CROWE. Absolutely. I can tell you if you are talking about the cuts you just mentioned you are going to see some cut-

backs and some I suspect even you are not going to like. We talked about it earlier in regard to the request for what it would look like at $288 billion. What I can say is what I mentioned in my summary—we are looking at a total package as we have traditionally in the military. Since we are going to be looking to be outnumbered to begin with, and outgunned to begin with, we are looking at a package that is very carefully drawn that leaves us very little margin.

I must admit I am a little appalled at some of the figuring and the accounting we are doing and how we are doing the defense budget by stubby pencil. Our programs can be paid for, but what you are saying is, you want to buy something else instead of defense. That is what we are saying here in this room today.

Mr. FAZIO. I am saying SDI is buying something we can't afford and that the Congress appears to want to live with it without new revenues.

Admiral CROWE. I understand that. The programs, what we have and what we lose if we don't have them, compared to other demands on the budget, should not be automatically cut 6 percent or 28 percent or 30 percent, and then we will worry about what is going to happen to military capability. Now, when I was in the Pacific, people asked me the question, where do we stand in the net assessment vis-a-vis the enemy or our most likely potential adversary, the Soviet Union?

I told them there was a time about 10, 15 years ago when we were extremely concerned with the state of our preparedness and looking toward the threat. We thought the risk was way too high, and military people were saying that all the time. If you had asked a man in my position then, I think he would have said, "In a major confrontation with the Soviet Union, I have no confidence we would prevail."

We have made great improvements in our readiness, our sustainability, our training, and our modernization. I used to say as a result of those 3 or 4 years of improvement in the Pacific, that now it was too close to call. It was not only too close for us to call, it was too close for the Soviets to call. We have stuff in the pipeline that is going to improve our position now for another 2 years. If that stops, the future is what I am worried about. If that stops, we are going to go back to those years where we didn't have confidence that we prevail.

The question you have to face is is that a proposition militarily and security-wise for the leader of the free world to be in. Are these other things more important than us keeping our state of readiness in that kind of condition? Are we willing to live with that uncertainty, that doubtfulness?

If you lose your security—we are talking about large sums of money here, but these sums are nothing compared to what it will cost the day deterrence fails. If we have to go to war we will be, in similar periods of time, spending 50 to 100 times what we are talking about here. Deterrence is very important to the general welfare.

Mr. FAZIO. We understand the need for strong deterrence. We have been hearing a lot of talk about our need to build up strategic weapons and defense weapons over the last 5 years, but we are now in a position to make some choices. It ought to be obvious to every-

body in both bodies, both parties, and hopefully at the Pentagon, we have run out of running room and we have to choose. This is something I think we needed to do all along.

We need people wearing military uniforms to help step up to the table and make some choices. We can't do it all. We can't do it all at the pace we would like to do it, and if we don't have the leadership of the Joint Chiefs, the heads of the services, I think we are going to end up making decisions here that perhaps aren't going to sit very well with people who have professional responsibilities as you have.

I would hope that you will become part of the solution to our problem. I hope you will show some courage and some leadership. I hope you will speak with an independent voice, one that fulfills your responsibility, not just to the President, but to the Congress, and to the American people. We are going to need to hear from you over the next several months like we have never heard before.

Admiral CROWE. We will give it our best shot, Congressman.

Mr. LOWRY. The gentleman from Michigan.

Mr. WOLPE. Thank you very much, Mr. Chairman. I have two quick questions.

Mr. Secretary, in your discussion of the procurement question, you indicated that today 72 percent of the contracts were being competitively awarded.

Mr. WEINBERGER. Right.

Mr. WOLPE. If you were to translate that into dollar figures, what percent of the procurement dollars?

Mr. WEINBERGER. It is measured by dollars.

Mr. WOLPE. You said contracts.

Mr. WEINBERGER. It is measured by dollars.

Mr. WOLPE. About 72 percent of the procurement dollar is now being competitively awarded. Is that what you are saying?

Mr. WEINBERGER. Right.

Mr. WOLPE. Admiral, in your testimony, you make a reference here to the second 50 MX missiles being in addition to urgently needed continuing research for placing the second 50 missiles and development of a smaller ICBM mobile launcher. Are you indicating the Pentagon is planning to move ahead with the development of 50 MX missiles beyond those that have already been authorized, irrespective of the limitation placed by the Congress on that MX missile program?

Admiral CROWE. Well, as I understand it, sir—and I will ask the Secretary to comment on this—we are tasked, first of all, to come up with a basing study and that is what we are in the process of doing right now. Once we have completed that we would, yes, be seeking 50 more.

Mr. WOLPE. So, the MX missile is still much alive.

Mr. WEINBERGER. It is based on the number of Soviet hardened targets we have to cover in order to maintain adequate deterrence, and we do need 50 more.

We understand that Congress has some problems with some of the basing modes, and we are spending some research funds to try to develop a mode that will be acceptable to the Congress. We do need to have an additional 50 MX missiles deployed and ready to

go so that the Soviets will know that we can cover their targets, and therefore they will refrain from trying to hit us.

Mr. WOLPE. Let me just say I find that absolutely mindboggling. That is one issue I thought perhaps we were not going to have to fight this time around, and to see that one revisited is extraordinary, given the balance of your own testimony, Mr. Secretary.

Let me say that earlier, when there was some discussion of the court decision today, your glee was evident when you learned the court had in its initial holding found that the GAO automatic mechanism for——

Mr. WEINBERGER. I hope it wasn't evident. I didn't feel any particular glee.

Mr. WOLPE. I thought you wanted to be excused to go back and come up with new figures instantly. I misunderstood that.

Mr. WEINBERGER. I was attempting to inject a light persiflage with the chairman at that time to help us break some of the tension that has built up over the morning.

Mr. WOLPE. I think it worked.

Let me say whatever the constitutionality of the automatic cutback mechanism is found to be one thing we cannot do is to declare the Federal deficit unconstitutional. Maybe we can repeal Gramm-Rudman, but we cannot repeal the Federal deficit.

It seems to me, Mr. Secretary, that the issue that is before this Congress and before the American public right now that has very little to do with whether or not one is committed to providing for national security.

Clearly, we all share that commitment. The real issue is how can our national security be provided in the midst of the collapsing economic base for our society.

Mr. WEINBERGER. I certainly wouldn't call it a collapse.

Mr. WOLPE. Let me finish my statement and then I will be glad to ask you to respond to that. The President's budget, in my view, makes a terribly serious mistake in providing an extraordinarily narrow definition of national security to be simply the size of the arsenal, without any consideration of the productive capacity of the Nation required to produce the weaponry and to produce the technology required to provide the national defense.

There was an interesting quote just a few days ago in the Washington Post by Regis McKenna from the Silicon Valley.

He said:

> While military spending has increased, our competitiveness in commercial and industrial markets has dramatically declined. Over the past few years, there has been a pronounced shift in our spending patterns toward military-oriented development, specifically weapons development.
>
> No jobs are created by missile development. No new wealth is created to cycle back into the innovative process. It does not improve our standard of living, improve productivity or create opportunities for growth.

Mr. Secretary, the huge increases in military spending that you call for in this budget are very simply robbing the entire economy of those resources for other investments that are crucial to maintaining our economic vitality and strength and hence, national security.

You are calling for a 25-percent increase, for example, in the funding for Department of Defense research and development. At

the same time, the same budget calls for a 25-percent reduction in Federal support for higher education.

How can we maintain the highest level of commitments with respect to research and development that maintains the competitiveness of our overall economy with that kind of reduction? Are you not troubled by the call for a 25-percent reduction in support for higher education? Doesn't that trouble you from a national security standpoint?

Mr. WEINBERGER. From the point of view that you are mentioning it, Congressman, it sounds rather bad, but when you compare it to the base from which the reduction is made, I think the facts are mitigated. The most important fact is one for which we are also criticized, and it is that the great bulk of the research and development contracts of the Defense Department go into universities, colleges, and laboratories where a lot of the important work is done.

So, while we are criticized for spending too much on R&D in the Defense Department, and while the same people criticize the President for not spending enough in the universities, what we fail to recognize is that the Defense expenditures on R&D do go into the universities and do help them very much. They go into and are used by universities as part of their overhead and as part of their ability to employ faculties which are indeed the pride of the country.

Mr. WOLPE. Mr. Secretary, the same kind of increase in military R&D that you take great pride in pointing to as contributing to our economic security has been associated with widening trade deficits because of the declining productivity and technological adaptation of the commercial private sector of our economy.

Mr. WEINBERGER. I hope we are not going to be blamed for that, too.

Mr. WOLPE. Are you saying we have not remained technologically competitive, notwithstanding the increases in military R&D expenditures are not going to sustain and improve the civilian part of our economy?

Mr. WEINBERGER. No; a great deal of the military R&D helps the civilian economy, and all of us. It has a very large commercial, as well as nonmilitary fallout. The problems that we have with respect to maintaining our lead in technology are appreciably the problem of the degree of Soviet theft of our technology, which has indeed made us worry very considerably about losing some of that technological edge.

Mr. WOLPE. Are you saying why the steel industry, textile industry, auto industry, the machine tooling industry are having difficulty is because the Soviets are stealing our technology?

Mr. WEINBERGER. No, I didn't say so. What is happening with a lot of those industries is they are up against competition that is in many cases government-supported or supported by trade practices which we are trying our best to eliminate, and which we are having some considerable success in eliminating.

But if you reduce the defense budget by the amounts that are talked about here, then you are going to see some real problems with the American economy, but that is not a reason for not reducing it.

The reason for not reducing the defense budget is that if you don't have a strong defense and maintain the deterrence, then all the other things that you and I are interested in are at peril.

Mr. WOLPE. If the economy collapses, so does our national security, Mr. Secretary. Thank you.

Mr. LOWRY. The gentleman from Montana.

Mr. WILLIAMS. Thank you, Mr. Chairman, and thank you, Mr. Secretary.

Let me start, Mr. Chairman, with kind of a general statement. I want to be clear about the fact that those who might reject the Reagan defense budget are not necessarily for a second-rate defense.

In fact, I don't know anyone that is in this Congress or in this country who doesn't want a strong defense. But I know, Mr. Secretary, that you understand that there are just as many Americans who believe that we don't have a first-rate defense.

In fact, they believe that it is woefully inadequate and that the Pentagon is comprised of three bureaucratic fiefdoms who are concerned about protecting their own fiefdom rather than protecting the defense of this country. The result is waste and inefficiency, and quite frankly, incompetency down at the Pentagon. It results in things like our young men freezing to death on the Yalu River because their winter clothing isn't adequate, or our helicopters going belly up because of a sandstorm and the loss of life on the way to rescue hostages in Iran, and the loss of life of American marines at an airport some place in the Middle East.

Americans keep going to these funerals saying wait a minute, what are we paying for here, we are naked to terrorism.

American military shot each other in Grenada. What are we paying for here? So you see, we are on the same side, it is just that we might find different ways to get there. One of the ways we can get there, Mr. Secretary, is when you level with us about precisely what is going to be cut if a certain budget level is reached.

We need to know that, and I understand that Chairman Gray and Congressman Gradison on the other side of the aisle have asked you to send us the specific cuts that will have to be made given certain budget levels.

Now, you talked to us about some of those specific cuts last year if a certain budget level was reached. In fact, you got less money than that budget level, so let me ask you what happened? Did you allow the B-1 bomber to be delayed by 4 years?

Mr. WEINBERGER. We did not; no. We certainly didn't pick out the things that would cost us the most both in dollars and in security. We picked out the things we had to pick out and I have got a long list of them here and I will be glad to read them for you.

But we certainly didn't stop things that were half or three quarters programmed and where the cancellation costs would have far exceeded any reasonable sum, and we would have ended up with nothing. We didn't do that, no. We tried our best not to hurt national security.

Mr. WILLIAMS. That is good. I hope in this letter you send up you will be at least that specific about what you are really going to do and what you aren't going to do, because last year you told us if

you didn't get $294.7 billion you were going to have to do certain things. You ended up with $286 billion.

Some of the things you told us you were going to do was let the B-1 bomber slip for 4 years; 38 percent in tactical aircraft; 50 percent reduction in Army and Air Force helicopters; terminate the heavy-lift helicopter program; and terminate the C-17 program.

You said, and I quote: "We will pretty well stop the multiple rocket launch system." And you said: "We would have to slip the Trident-2 missiles by 2 years."

Now, you and the admirals and the generals come up here and you plead and you predict and you threaten and you do end runs and slam dunks and you huff and you puff, and, quite frankly, Mr. Secretary, you are out of gas. We don't believe you any more.

Mr. WEINBERGER. It is fortunate that the American people don't believe you, Mr. Williams, because when you talk about the problems on the Yalu River you are talking about something that happened when I was in the State Legislature of California.

When you talk about the helicopters that were not able to make the rescue in Iran that were supposed to—our helicopters in Iran—you are talking about some of the products of cutting back defense for a very long period, a decade, and you get that kind of result.

When you talk about Grenada you talk about something we won. Fortunately, the American people have a totally different view of this, and they expressed it in 1980, they expressed it in 1984. What we are presenting now are the things to prevent the kinds of things that you spoke of that happened years ago when we let our defenses go down. It is all right to do it in the abstract, I guess, and it makes everybody feel better if you can say that finally we got them down to a minus figure.

But, of course, what would be the real problem if you found that deterrence had failed because of your actions. So, I don't have too much in the way of concern about what the American people will decide ultimately. They are usually right.

The important point I want to make is that we have timed it correctly. We do the necessary things that we have to do so that we are not in a situation where we don't have time.

As far as the inadequacy or the poorness of the American military force now which you seem to make a fettish out of, you made that point last year. I would like to have Admiral Crowe comment on that again.

Admiral CROWE. Well, I mentioned it earlier, Mr. Williams, when we were talking about it. I stand by my statement—we are better off now personnelwise, and readinesswise, than we have been in my time in the military.

These are the best people I have seen in 40 years of service, and they are better trained. I just plain don't agree with you when you say they are incapable and incompetent, and I am curious if you visited many of them lately.

Mr. WILLIAMS. Admiral and Mr. Secretary, it is interesting that whenever high ranking officers or the Secretary are told that the military isn't all it should be, you immediately return and say———

Admiral CROWE. I didn't say that.

Mr. WILLIAMS. Do you say the fellows under arms aren't what they should be?

We don't say that they are incompetent. That is not what we are saying. You miss the point.

We are not saying they are sloppy or that they don't do their best, or that they don't give their lives for someone elses incompetence. That is not what we are saying.

Admiral CROWE. You have got a lot of fine military organizations that the leadership in the military participated in—I happen to be very familiar with the submarine business.

We have the best submarine force in the world and that is partially due to the leadership in the submarine force. I don't think that is disputable. We have an air force that is second to none.

I have in front of me a list of improvements made in Tactical Air Command in the last 5 years that are just mindboggling, how much they have achieved and for which the leadership is partially responsible.

I would never argue or pretend we don't have some problems or that we do everything perfectly. We are working very hard to correct the things that we think are wrong.

But I certainly don't subscribe to the view that you expressed earlier that our country is naked in front of terrorism and that our people are incompetent and can't perform their job. I don't believe that.

Mr. WILLIAMS. Mr. Chairman, finally let me just say that each of these instances, whether it is years ago when Secretary Weinberger was in the legislature, and I was probably in the fourth grade, or whether it is yesterday at terrorism, I purposely picked each instance because they occurred at a time of the greatest military buildups in history, each of those instances.

We were pouring more money in when those things happened than any time in history. They didn't come at a time when the curve had reached the bottom and we weren't taking care of our resources. They came when the curve had hit the top and that is what concerns the American people.

They just want to know they are getting the very best military that they can buy and the majority of people in the United States don't think they are getting the very best military they can buy, and frankly, and unfortunately, I find myself in agreement with them. Thank you very much.

The CHAIRMAN. I believe, Mr. Secretary, that ends all of the members of the committee on the Democratic side.

Mr. Gradison, would you like further questions?

Mr. Secretary, I want to thank you again for coming before us and being our first witnesses and also you, Admiral Crowe. This was your first time, as we say, being in the pit and we hope that you have perhaps enjoyed it to some degree.

I certainly want to thank Secretary Weinberger because I think this is his third or fourth hearing in 3 days where he has gone before many, many committees and I want to thank him for being willing to come here after 2 or 3 gruelling days before other committees, and testifying on our national security.

So, Mr. Secretary, let me thank you for your tireless efforts on behalf of this Nation and although there are times we don't agree we all are concerned about the same issue. We look forward to

working with you as we go to the process of putting a final budget together.

May I also ask that written replies to the members questions would be supplied for the committee record, specifically the questions that were asked by the gentleman from Ohio and any other questions that were asked which we expect written replies.

So, thank you, Mr. Secretary, thank you very, very much.

Mr. WEINBERGER. Thank you, sir.

I would like to comment again on the great courtesy and fairness and wisdom with which you have presided over this hearing, as is evident throughout your whole career. It is a pleasure to appear before you, sir.

The CHAIRMAN. Thank you, Mr. Secretary. Admiral Crowe, good luck.

Admiral CROWE. Thank you very much.

The CHAIRMAN. The hearing is adjourned.

[Whereupon at 1:10 p.m., the hearing adjourned until Tuesday, February 18, 1986.]

The following additional material was submitted for the record:]

PREPARED STATEMENT OF SGT. MAJ. C.A. (MACK) MCKINNEY, LEGISLATIVE COUNSEL, ON BEHALF OF THE NON COMMISSIONED OFFICERS ASSOCIATION OF THE USA (NCOA)

Mr. Chairman. The Fiscal Year 1987 Defense Budget contains a request for $74.2 billion in appropriations for military personnel. According to the chairman, House Appropriations Subcommittee on Defense (HASD), this sum is about $2 billion greater than that for fiscal year 1986. The major increase results from the Administration's request for additional manpower; 14,000 for the active forces and 52,000 for the selected Guard and Reserve.

Using the HASD chairman's figures the additional personnel for FY 1987 could cost $500 million in FY 1986 dollars (based on average cost per servicemember in FY 1986), or about one-fourth the $2 billion increase referenced in the preceeding paragraph. Yet, there is a pay increase of 4 percent programmed for military personnel costing $2.6 billion. Apparently, since these two new items add to a $3.1 billion total there is a savings of about $1.1 billion somewhere in the Department of Defense (DoD) outlays for earlier years. The difference is shown on the following page.

SUMMARY OF BUDGET REQUEST FOR ACTIVE AND RESERVE FORCES

(In millions of dollars)

Fiscal Year 1986

	Enacted	Proposed sequestration and transfers	Total Fiscal Year 1986	Fiscal Year 1987	Change
Active Forces	$59,610	$3,894	$63,504	$64,738	+ $1,234
Reserve Forces	8,296	358	8,654	9,465	+ 811
Total	$67,906	$4,252	$72,158	$74,203	+ $2,045

Fiscal Year 1987

	Pay Hike	(Est.) Cost Added Manpower	(Est.) Total	Change	(Est.) Difference
All Forces	$2,600	$510	$3,110	$2,045	$1,065

Note: All figures above except those estimated "(Est.)" are quoted from the HASD chairman's remarks printed in the CONGRESSIONAL RECORD, February 5, 1986, pp H 351-354

NCOA believes much of the difference is derived from savings related to costs paid in 1985 and 1986 directly to military retirees and their survivors. U.S. Treasury figures show an actual decrease in costs during 1985 amounting to $670 million. Another $400 million-plus may be realized in 1986 if the cost-of-living adjustment (COLA) to retired pay and survivors benefits is not paid. The total savings is about $1.07 billion.

Wherever the difference is credited, NCOA is concerned that any reduction in the FY 1987 military personnel account, triggered by the Gramm-Rudman-Hollings budget legislation or by a cost-conscious Congress, may cause DoD to seek a decrease in active-duty year-end strengths. Hardest hit would be the enlisted corps, many of them with five or more years of credible service. For them there is no severance or rehabilitation pay.

Some years ago NCOA attempted to have Congress address the blatant and inequitable practice of offering severance or rehabilitation pay to the majority of its federal workforce, including commissioned officers of the uniformed services of the United States and foreign employees, but not to enlisted personnel of the Nation's armed forces. A number of Congressional bills were sponsored in the Senate and House, but oversight committees refused to hear arguments for consideration.

DoD said it couldn't support the legislation because enlisted personnel could "cash-in" up to 60-days unused leave at the end of every enlistment. Officers could not. However, in the mid-1970s the law was amended limiting "cash-ins" for enlisted personnel the same as for commissioned officers. "Now," said NCOA, "severance pay for enlisted personnel can be addressed."

But it wasn't. DoD and then some-incumbant committee chairmen made the excuse that severance pay was really a subject

to discuss only when the military retirement issue came up again in Congress. They stuck by this half-baked reason even after the Defense Officers Personnel Management Act (DOPMA) was adopted a few years later. The amount of severance pay for commissioned officers went from a maximum of $15,000 to $30,000. Still there was no relief for discharged enlisted members with the same number of years of honorable service as may be required of the officers to qualify for severance payments.

Even today- some ten years after enlisted personnel lost eligibility to "cash-in" 60 days of unused leave at the end of each enlistment- there is no severance pay for them. Last year, when DoD submitted the two options prescribed by Congress to change the military retirement system, neither one addressed severance pay for enlisted personnel.

Because there is a probability the defense budget will be cut, the military services may resort to reductions in active manpower to offset losses in FY 1987 personnel appropriations. NCOA urges your distinguished panel to approve the personnel request and look elsewhere in the DoD budget to reduce funds, if such reductions are mandated. NCOA believes that procurement funds, particularly those for some strategic weapons and naval ships, can be cut or delayed so the Nation can maintain the positive manpower readiness capability it enjoys today.

Hopefully your colleagues will agree that in the absence of

law addressing the severance pay issue for enlisted personnel and because the current force has displayed outstanding performances in accomplishing its missions, no reductions in appropriations for the active forces should be considered. However, funds requested to add 14,000 active duty and 52,000 reservists should be diverted to pay military retirees and their survivors a cost-of-living adjustment (COLA) in FY 1987- one that was unfairly denied them in 1986 and not included in the Reagan budget for 1987- and to help retain the current military retirement system.

NCOA believes it is imperative that Congress support the COLA over the President's objection. Further deterioration of promised retirement entitlements will adversely affect the current forces. Experienced and highly-qualified personnel will do what their older comrades did in the 1970s- vote with their feet. The Nation can ill-afford a reincarnation of those days, then later appropriate more funds to rebuild the damages done earlier.

Deterioration, by the way, also includes any adverse changes in the current military retirement program, even if it may be grandfathered. Servicemembers are well-versed in congressional actions reducing military retired pay benefits ever since Congress changed to the COLA system in 1963. They won't buy the "grandfather" premise anymore than they believe today's Congress will keep its promises to current military retirees. Thus, NCOA

asks Congress to fully fund the military retirement accrual account to cover future costs of military retirement at current compensations, as contained in Title 10, United States Code.

In his Fiscal Year 1987 report to Congress, Secretary of Defense Caspar Weinberger begins by stating: "Debate about the defense budget, especially in an era of deficits, rarely focuses on the big picture. Too many of us cannot see the forest for the trees. Even worse, some of us get caught up in the leaves. In an effort to help us all keep some perspective on the forest, let me identify the four central questions each of us should ask ourself in thinking about U.S. defense programs and budgets."

Mr. Weinberger proceeds with the first three questions then states the fourth is rather difficult to answer- whether our defense budget is being spent wisely and effectively? He falters in providing a response to which is most effective for the price tag, is it wiser to spend money on people or weapons?

NCOA Unequivocally states that the answer is people. The current chairman of the House Committee on Armed Forces apparently agrees for he said late last year that an analysis of the $1 trillion spent on defense over the past four years shows a dramatic improvement in personnel. Further, he said, that improvement was "the only unqualified success." All other military capabilities, he noted were "at best, marginal."

Even more convincing should be the statement made years ago by the late General George S. Patton, Jr.- "Wars may be fought with weapons but they are won by men."

IMPACT OF THE PRESIDENT'S 1987 BUDGET

TUESDAY, FEBRUARY 18, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 1:40 p.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The CHAIRMAN. The Budget Committee is pleased to welcome this afternoon James C. Miller III, Director of the Office of Management and Budget. We are pleased that you could be with us for this Washington hearing on the fiscal year 1987 budget as submitted by the President.

We welcome you, and we also note that this is your first appearance before the Budget Committee, and therefore we had the presentation, Mr. Miller, to give to you as you arrived.

Last week the House Budget Committee concluded 5 days of field hearings on the Federal budget for fiscal year 1987. These hearings covered a variety of budget issues, including Federal aid to State and local government, Medicare, Medicaid, and other health programs, job training programs, crime and drug interdiction programs, veterans programs, farm programs, the impact of the budget on the oil and gas industry, defense spending, tax amnesty and tax collection programs, the impact of the budget on the poor, the elderly and children, the Federal role in protecting the environment, the Federal role in providing transportation assistance, Federal support for higher education, and Federal funding for AIDS research.

What folks were saying was they don't like the President's choices. Hearings were held in the Northwest, Northeast, Southwest, Southeast, and Midwest. I must inform you that, based on these hearings, there is not a great deal of support for the priorities expressed in the budget before us. However, there is great support for deficit reduction.

In addition, I am deeply concerned that the President's budget does not meet the maximum deficit amount of $144 billion as required by the Balanced Budget and Emergency Deficit Control Act of 1985, better known as Gramm-Rudman.

It appears to me—and CBO has confirmed—that for your national defense spending proposal, the estimated fiscal year 1987 outlays of $282.2 billion are at least $14 to $15 billion lower than expected.

On the basis of historical spending rates in different defense accounts, from the budget authority of $286.1 billion in fiscal year 1986 and $320.3 billion in fiscal year 1987 which you have pro-

posed, CBO has reestimated your budget proposal at $296.9 billion, $14.7 billion above your estimate, and other respected analysts concur that the outlays in the budget are underestimated.

If this is true, the administration's deficit is not $144 billion but at least $159 billion. This does not meet the deficit level required by Gramm-Rudman. I hope you will be able to shed some light on this discrepancy this afternoon.

My deep concern about these outlay estimates stems from the serious consequences which may follow inaccurate budget estimates this year under the Gramm-Rudman Act. CBO has analyzed the deficits from fiscal year 1980 to fiscal year 1984 and concluded that the deficits were, on average, underestimated by almost $40 billion per year because of changes in economic and technical assumptions as the year progressed.

Clearly, it is essential this year that we use realistic and even conservative estimates in budget planning. The Gramm-Rudman sequestration is very sensitive to change in the deficit estimate, which in turn is very sensitive to changes in the economy.

For example, if unemployment goes up 1 percentage point, then the deficit could go up between $30 to $40 billion. Assuming that Congress and the President cannot agree on a deficit reduction plan by August 1, domestic sequestration could be between 14 and 18 percent higher than it would otherwise be. We would be faced with domestic across-the-board cuts of up to 30 percent.

According to press reports, you have stated that if Congress adopted the President's budget, automatic sequestration would not be necessary. We certainly hope so, Mr. Miller, and let me assure you that there will be a fair hearing and a vote on the President's budget as submitted; but if necessary, I believe the House will take the lead in fashioning a budget that will balance our domestic as well as our defense needs within the constraints of a very confined fiscal environment.

Mr. Miller, these are just some of the issues that we hope you will address. We look forward to having you testify, and we welcome you to the Budget Committee on the House side for your first appearance as the Director of OMB, and in light of the awesome responsibilities that you have, we wish you well.

Before you proceed with your testimony, I would like to call upon the senior member of the minority side. As you know, Congressman Latta is recuperating, but we have Congresswoman Lynn Martin who is acting as the ranking member. Perhaps she would like to have a few opening comments of welcome to you. Congresswoman Lynn Martin of Illinois.

Mrs. MARTIN. Thank you, Mr. Chairman.

We look forward to working with the chairman and with our colleagues across the rotunda to fashion a budget. We welcome the President's as a base on which to make decisions. We recognize that no President's budget has ever been fully accepted and that, indeed, the Congress must and should make some changes.

I wonder if briefly, Mr. Chairman, I might comment, and I will certainly be happy to give to you—and I'm pleased to see the majority leader—a comment from the Republican leader. The Republican leader wrote to the Speaker on February 6 requesting that the Speaker appoint a Members user group which was called for in

Gramm-Rudman, and we will have copies of that letter for each member of the Budget Committee panel.

Such a group would decide how to deal with the scorekeeping and the other technical issues, which, the chairman points out quite rightfully, are so important. The utility of such a group would be to provide an open and bipartisan forum to deal with these technical issues which, nevertheless, carry significant policy implications. A perfect example is the debate which the chairman has brought up about the reestimation of the President's budget.

Mr. Chairman, you have decided unilaterally that the CBO spendout rates for national defense are more accurate than OMB's, which historically may or may not be the case. It is not our judgment to sit and support OMB against CBO but, in the spirit of Gramm-Rudman, to look for agreed numbers.

You have indeed said that those numbers will be so and that the President should resubmit the budget. Republicans are more than willing to work with the chairman to examine issues such as this on their merits, but it is difficult if we are not afforded that opportunity.

A Members user group would be the mechanism to reach such agreement, which should be bipartisan and not need to be involved with a partisan debate. We would hope that you would use your considerable powers and ability to convince the Speaker and the majority leader that this would be an excellent start and, I might add, that they would answer the Republican leader's letter since we do not have an answer to it as yet.

With that in mind and understanding that will be one of the questions, we welcome Mr. Miller, whom, I may say, is really terrific to work with. He is very nice, very easy. When he is wrong, which, as I have explained to him, is any time that I disagree with him, he has been most kind in agreeing to recheck, and I think he has a real and deep commitment to not only representing the President, which is his role, and to do that well, but to work with all of us as we try to meet in this first year the Gramm-Rudman goals, and I welcome him along with the chairman.

The CHAIRMAN. Thank you, Mrs. Martin.

Again, welcome, Mr. Miller. We look forward to your testimony and your answering some of these questions, and we look forward to working with you as we have already begun to do so this year on the fiscal year 1987 budget.

We would hope that you would summarize your testimony, and your formal statement will be entered in the record its entirety. Please proceed.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Thank you, Mr. Chairman.

I had some anxiety when I came in, and I saw your sign, and now I'm sitting here in fear and trembling. But I do look forward to a productive relationship with the committee, and I welcome this opportunity to kick it off.

It is a pleasure to try to respond to some of your questions or have the opportunity to do so. Let me just run through right quickly.

I think what I can do is summarize my testimony to some extent by saying that we have had 35 plus months of rather vigorous expansion in the economy, and I think this harks back to the predicate for a good, solid expansion that was set when the President announced his four-point program in February 1981 of stable monetary policy, regulatory relief, tax cuts, and budget restraint, and that is in the inverse order.

We have followed up on that with this budget, meeting the $144 billion target required under Gramm-Rudman-Hollings, but at the same time trying to do it in such a way that it poses the least jeopardy to the expansion that is raising incomes for all Americans.

The budget, as I will describe in just a little bit, does this without raising taxes, without sacrificing our defense preparedness, and without cutting into vital programs for the poor and the elderly. I think a tax increase would pose certain hazards to our expansion. I think the polls show that the public doesn't want it.

I think that defense cuts would pose a hazard to our national security, and I think that we want to avoid hitting the poor and the elderly.

Now, the President's fiscal year 1987 budget has outlays of $994 billion and receipts of $850.4 billion, and thus the budget proposals would hold the deficit to $143.6 billion, or $400 million below the Gramm-Rudman-Hollings maximum deficit target for 1987.

On a current services basis, outlays are estimated at $1,025.9 billion, receipts at $844.1 billion, resulting in a deficit of $181.8 billion. I think we all agree, and as you indicated, Mr. Chairman, in your discussions with people in your hearings, the American people think that is too high a deficit.

We propose to reduce the deficit, then, by $38.2 billion from the current services level, $6.3 billion of this amount coming in the form of higher Government revenues. The receipts are largely a result of increased employee contributions to Federal retirement funds, initiatives by the IRS to collect more taxes already owed, and accepting the all-but-inevitable extension of the extra 8 cents per pack tax on cigarettes.

An additional $3.2 billion comes from selling various real estate and financial assets, increased user fees account for $2.4 billion, and the reduction in the deficit saves some $1.2 billion in interest expense. This leaves $25.1 billion to be derived from programmatic reductions; $2.7 billion of this comes from reducing defense funding while preserving the 3 percent real increase in defense, leaving only $22.4 billion of the $38.2 billion—or in other words, about 60 percent—to be obtained from cuts in domestic programs, defined as everything except national defense, Social Security benefits, which are off limits, net interest, and undistributed offsetting receipts.

We believe that these proposals, if enacted, would cut the current services base for these domestic programs by less than 5.4 percent. I repeat, the $22.4 billion cut comes on a base of $418 billion. So the amount that we are looking at is not that great.

What we tried to do in putting the budget together is to ask: Is this logically a Federal function or is this something that might be

transferred to State or local government or to the private sector to operate as well or better? But for those things that remain in the Federal Government, we ask first do we have the right amount, do we need to expand it or contract it? Or perhaps if it's a program that is no longer useful, then we would end it.

But for those things that we keep in the Federal Government, one of the things that we have done is try to find if there are more cost effective ways of providing the good or service, less cost for providing the same service, or for the same cost, improving service delivery, while maintaining—in some cases, expanding—high priority programs in crucial areas of national interest. Services and income support for the dependent poor and the elderly receive substantial funding. So do other programs of national interest, including drug enforcement, AIDS research, the Space Program, nonmilitary research, and national security.

National security programs continue to be one of the President's highest priorities. They have not been exempt from general budget stringency.

I will just tell you straight on, Mr. Chairman and members of the committee, that the service chiefs asked for a lot more money even than the CBR baseline, but they were cut back from that.

Keep in mind that since 1984, the President has agreed to large reductions in requests for defense budget authority. The Rose Garden agreement in May 1984 cut $55 billion from the proposed fiscal year 1985 5-year plan. Congress then reduced the agreed-to Rose Garden level for 1985 by an additional $8 billion.

In the fiscal year 1986 budget, the administration reduced the Rose Garden 5-year levels another $37 billion, due, in part, to revised pay and inflation assumptions.

Last year, the CBR, which the President reluctantly agreed to, provided no real growth for 1986 and only 3 percent a year thereafter, and that cut $290 billion over 5 years from the President's request.

So the President has already compromised on defense, and he has compromised in a very large way. And of course, as you know, Congress did not give the full zero percent real increase for fiscal year 1986, and then in addition there was the sequester, the Gramm-Rudman-Hollings sequester.

Now I think I will respond at the very end to a couple of the questions that you raised at the beginning. But I would like to touch on the question of the OMB's estimates of defense outlays.

I want to reaffirm that our estimated $282.2 billion for fiscal year 1987 for national defense is according to our best judgment, as I indicated to you in a letter, Mr. Chairman. Estimating outlays is a very complex task. It depends not only on program composition and historical outlay rates, but also on a variety of factors external to the defense program. It is also important to remember that for each of the past several years, OMB has actually overestimated defense outlays, by $4 billion in 1983, by $10 billion in 1984, and $2 billion in 1985. Now current estimates take into account our propensity to overestimate and make some adjustment for that.

As a benchmark, it should be noted that the budget estimates for defense outlays are higher than they would be if we had adopted as our starting point the assumption in the 1986 budget resolution ap-

proved by Congress. This is true even though our projected outlays of $282.2 billion are less than those of the resolution, which is $285.2 billion.

And I need to explain. Resolution outlays were based on the budget authority of $302.4 billion for fiscal year 1986, and a fiscal year 1987 total of $323.4 billion. However, the final 1986 amount, after congressional action on the CBR and the sequester, was only $286.1 billion or $16.3 billion less than the resolution. The proposed fiscal year 1987 amount in our budget is $320.2 billion or $3.1 billion less than the resolution. So we've had the sequester, and we've asked for less in 1987, and some of the sequester amounts would pay out in fiscal year 1987.

So the fiscal year 1987 reductions in outlays stemming from the sequester and stemming from our asking for less money reduces outlays by $8 billion for 1987.

Now given what has actually happened, the resolution outlays would fall from $285.2 billion to $277.2 billion. Thus if we had used the resolution assumptions approved by Congress just last August, our fiscal year 1987 outlay estimates would have been $5 billion lower than the $282.2 billion figure contained in the President's budget.

Although we think that outlay rates will be somewhat higher than those assumed in the resolution, they are likely to be lower than might have been estimated based on some past experience for several reasons.

For example, the effect of the continuing growth of the economy would shift corporate attention from defense to nondefense orders. Also possible delays in deliveries might result from procurement reforms instituted by the administration and legislated by Congress. And there are other possible uncertainties associated with the effects of Gramm-Rudman-Hollings. Each of these effects should lead to some reduction in outlays.

Taking into account all of these factors, I believe that our $282.2 billion estimate is a very responsible figure.

Let me just say in summary on this point, Mr. Chairman, we believe that this estimate that we have in the 1987 budget is correct, again to the best of our knowledge.

Second, you posed the possible threat of a sequester if we have the wrong numbers, but we will have one-half of the answer that would determine whether there would be a sequester, if next August the Congress and the President have not agreed in a way that would avoid a sequester. OMB, as well as CBO, would be making these reports. Since the Supreme Court has not yet ruled, we do not know whether GAO would be involved, but I would predict that the lower court will be upheld.

So the second point is that OMB's methodology of today will be the same one used in August, and if there are no parametric changes that would alter our projections, the figures we'd arrive at would be virtually the same.

The third point I want to make is that, within relevant ranges, we, meaning the executive branch of Government, control the outlays. We decide what the outlays are. As you know, budget authority is sort of like transferring money into a checking account, and

outlays are when you write the check. I think for that reason there's some control over what outlays would be.

And finally, let's just assume for a minute that we're right and CBO is wrong, and we do want to get down to the $144 billion. In that event, I would say we would have to come up with more savings, and it seems to me that probably those who feel that the deficit is going to be larger than we had projected, the onus really should be on them to suggest where the additional savings might come from.

Now I did want to make note of the fact that accompanying the budget this year is our first management report. It reflects the Reform 1988 Program that we've engaged in to increase the performance of agencies. It summarizes the progress we've made in the areas of cash management and debt collection. It outlines future steps that will be taken to improve management of Federal loan portfolios and describes the efforts to upgrade agency financial systems for improved efficiency and better control. And finally, it describes the comprehensive program which is expected to boost Federal productivity in selected Federal agencies by 20 percent by 1992. This initiative will yield not only cost savings, but significant improvements in program delivery.

In general, the report indicates that sound business practices can be brought to bear on the Federal Government and yield positive results. We view the management side of OMB as coequal with that of the budget side. The two are very complementary. Our management reforms partially enabled us to get the budget deficit down. And through budget control and the expertise of our people on the budget side, we are better able to encourage the agencies to manage their operations more efficiently.

Now, Mr. Chairman, if I could go and present some material by means of charts, I would appreciate the opportunity.

As I have indicated, Mr. Chairman and members of the committee, the President's budget for fiscal year 1987 reduces the deficit by $38 billion, does not raise taxes, does not hit defense or penalize defense—it assumes the 3 percent real increase agreed to in the CBR—and it doesn't impair the ability of the elderly and the poor.

Let's go to the next chart.

Let me just briefly run over the revenue situation. This lower line is the current services revenue path over the period 1986 to 1991, and as you can see, it continues to rise. The President's budget has revenues at a slightly higher level, for the reasons that I just indicated, approximately $6.3 billion higher in 1987.

This chart indicates the reduction in outlays. Under the President's budget, outlays continue to rise throughout the period of 1986 through 1991, but at a slightly lower rate than envisioned under current services.

Mr. SLATTERY. Mr. Chairman, could you instruct the witness to move his diagrams a little closer, so those of us who don't have George Brett's eyesight can see this thing?

The CHAIRMAN. Mr. Miller, could you have your staff assistant pull those a little bit closer? We've got some eyesight problems over here.

Mr. MILLER. All right.

The CHAIRMAN. Age is catching up.

Mr. SLATTERY. Mr. Chairman, it's getting worse. [Laughter.]

The CHAIRMAN. Thank you, Mr. Miller.

Mr. MILLER. I bet you all really wish you could see what's going on. [Laughter.]

This diagram right here, Mr. Chairman and members of the committee, indicates the Gramm-Rudman-Hollings target diminishing from $172 billion down to zero by 1991.

The top line here is our estimate of the current services deficit. Like CBO, we see the deficit diminishing over time, but for slightly different reasons. We see that if there's no change in policy, the deficit will be in excess of $100 billion in 1991.

This line here, the lower part of the shaded area, is the President's budget. As you can see, we reach the Gramm-Rudman-Hollings target of $144 billion in 1987 and remain below that throughout this period of time.

I think that's a very important thing. Of course, early on, with some things leaking out on the budget, there was concern expressed by a lot of people, that because 1987 is just the first year of Gramm-Rudman-Hollings, there will be all these additional things next year.

The point is—and I think it's a very important one—if Congress approves the President's budget in toto, and our assumptions are correct, it means that we will meet the Gramm-Rudman-Hollings target deficit not only for 1987, but every year thereafter and have a balanced budget in 1991.

I don't believe that increasing taxes is the answer. I have indicated earlier that I think that it could jeopardize the expansion that's important to all of us. A tax increase could make the deficit worse, as a matter of fact, not better.

As you can see over the period 1970 through 1986, receipts as a proportion of gross national product have varied, but tended to return to an area of around 18 or 19 percent of the gross national product, whereas spending has increased. It's changed, too, but it's increased and given rise to the increase in deficit.

The President's budget would keep Treasury receipts at about a constant proportion of gross national product and bring spending down, and derivatively, we bring the deficit down.

There is a bipartisan consensus about Social Security. The President's budget does not touch Social Security. He views the trust fund as quite separate, a separate kind of contract. Nominally, Social Security will rise over the entire period, but will remain approximately a constant 4 or 5 percent of the gross national product.

The next two diagrams indicate why I don't believe that a defense cut would be appropriate. As you may know, the President's original parameter for defense was a steadily rising defense budget authority. President Carter, in his last year in office, proposed a budget that is indicated by the dashed red line in nominal expenditures. The lower line of the shaded area is what has actually happened. As you can see for 1986, spending is actually below the nominal dollar budget authority asked for by President Carter, and that's a $182 billion difference between what the President originally requested and what was actually appropriated by Congress over that 5-year period.

This chart shows real budget authority in constant 1987 dollars, and it shows, although it rose steadily through 1985, it was cut back in 1986, and is today at approximately the same level that it was for fiscal year 1984.

This shows that just a year ago, for the President's 1986 budget, the President had asked for expenditures over the period 1986 through 1990 looking like this, the top line. But in the congressional budget resolution of last August, the President agreed to zero, 3, 3 percent to much lower rates of the increase for defense. In fact, over the 5-year period, 1986 through 1990, the difference is $290 billion. This gives rise to the President's, I think, easily defended statement that he has already compromised on defense. But beyond that, the budget for 1987 asks for even less—$3 billion less in 1987 or a $45 billion additional savings from 1987 through the 1991 period.

Now at this point, I would like to just give you a picture of the whole budget. This is the entire budget broken down into four component parts—net interest, Social Security, national defense, and everything else.

This is the current services baseline, and let me hold it right here. This one that is just being put up is the President's 1987 budget. And if you will visually inspect them, you can see that they look very much the same. This one rises throughout; this one rises throughout as well, although at not as high a rate of increase for 1987.

Spending under the President's budget continues to rise as it does under current services.

Now what I'd like to do is to look at that all other category and talk about subcomponents of that all other category. That all other category consists of income support programs, major medical/retirement benefit programs, and all other activities.

This is the current services baseline, and up here is the President's budget. The difference, as you can see, is where this is rather constant for the year and then rises, it takes a small decline here and then rises throughout under the President's budget. So in terms of absolute magnitudes, there is not a big difference.

Keep in mind that for 1987, here we are trying to obtain a savings, including some offsetting receipts in the form of asset sales and user charges of some $28 billion, but that is on a base of over $400 billion, so that's about 6 percent.

Now I'd like to take each of those components and show them in a single chart—this is the current services baseline, and this is the fiscal year 1987 budget. As you can see, in terms of low-income support, there is virtually no difference between the two charts. The reason is that under the President's budget, we would be saving only about $700 million in fiscal year 1987, as opposed to current services, $700 million out of a base of about $40 billion.

The next chart shows major medical and retirement benefit programs. As you can see, they look very much the same, except the President's program starts at a little lower base, and the slope of the line is not quite as large.

For 1987, there would be savings of a little less than $10 billion on an overall base of about $190 billion, again less than 10 percent.

This diagram compares current services and the budget for everything else. As you can see, this is where the bigger cuts will take place. The current services budget is approximately constant over the 5-year period. The President's budget is approximately constant for 1987, and then decreases thereafter. That's $15 billion in savings on a base of about $180 billion, again less than 10 percent.

Now this last chart. I'm in the process of revising the chart because it's not as clear as it might be, but let me direct your attention to the various components. This is the savings from current services that is represented in the President's budget. As you remember, the budget deficit would be in the neighborhood of $100 billion under the current services budget in 1991. So we have to realize savings of about $100 billion in order to achieve a balanced budget by 1991.

There is a savings in net interest. Why? Because with a lower deficit, we have less debt to service.

Second, there is a wedge of savings for national defense from current services. We determined that the special inflation factor was more appropriately 1 percent rather than 1.3 percent, and we made some other changes which give rise to a wedge of savings for defense.

As a matter of fact, to drop down here and focus on this, this lower portion here of so-called undistributed offsetting receipts—that includes asset sales from privatization that are not distributed by agency or function. There's also a wedge, which does not appear, of distributed offsetting receipts. These include user charges and asset sales which are distributed by agency and are used to offset budget authority and outlays.

The blue area, of course, represents the reductions in other Federal programs. Of course, not shown here is also the $6.3 billion in revenue increases going to the Treasury.

So if I could just sum up by saying that this budget incorporates savings of $38.2 billion for fiscal year 1987, including about $12 billion in increased revenues, user fees and asset sales.

There have been calls for increased taxes and increased collections. About $12 billion of the $38 billion savings in the budget is increased revenues and collections—30 percent of the savings to reach the deficit target. Another $1.5 billion savings is in interest, and $3 billion in savings is in defense.

So $22.4 billion comes out of these domestic programs. What we've attempted to do in these areas is, where we can, adopt more cost-efficient ways of going about service delivery and provide the same services at less cost to the American taxpayer. We need to do that in any event. But some of those savings are through more cost-effective delivery techniques that do not hurt the recipients of these services.

Thank you, Mr. Chairman.

[Testimony resumes on p. 160.]

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF HON. JAMES C. MILLER III

Mr. Chairman and Members of the Committee: it is a pleasure to appear before you today to present President Reagan's budget for FY 1987. It is even more of a pleasure for me to be here at this time because of the economic expansion the country is now enjoying, one of the most vigorous in 35 years. Disposable household income is at an all-time high; production and productivity are increasing; and employment gains have been extraordinary. Inflation, which raged at double-digit rates just five years ago, has been reduced dramatically. During the past three years, real GNP has grown at more than double the annual rate of the last three years of the previous administration. The prime rate of interest and other key interest rates are less than half what they were five years ago. Also, during the past three years corporate profits increased 117 percent and stocks nearly doubled in value.

I could go on and on reciting positive economic indicators. The point is that the economic recovery that began in 1982 is now in its fourth year -- and it shows no sign of ending.

This dramatic turnaround in economic performance was not an accident. Rather, it was a result of steadfast adherence to the economic program the President presented in February of 1981:

- Restraining the growth of Federal spending;
- Reducing tax rates;
- Relieving the economy of regulatory excesses; and
- Encouraging a sound and stable monetary policy.

Conditions are now favorable to a continuation of our remarkable economic expansion. However, we must take cognizance of one major threat looming on the horizon: the Federal deficit. Unless we do something about the deficit, we risk not only a slackening of economic activity, but further burdening future generations with the costs of our current collective consumption.

We simply cannot let this happen. Therefore, the President's budget has as a major objective getting the deficit under control and achieving a balanced budget by FY 1991. In so doing, this budget meets or exceeds the deficit reduction targets set out in the Balanced Budget and Emergency Deficit Control Act, commonly known as Gramm-Rudman-Hollings.

Last fall, a bipartisan consensus developed to do something about the deficit. This consensus, which took the form of Gramm-Rudman-Hollings, committed both the President and the Congress to a reasonable, fixed schedule of progress. By submitting this budget, the President abides by the law and keeps his part of the bargain.

This budget shows, moreover, that eliminating the deficit is possible without raising taxes, without sacrificing our defense preparedness, and without cutting into vital programs for the poor and elderly. A tax increase would jeopardize our economic expansion and thus could even prove counterproductive in terms of its effect on the deficit. We cannot turn away from our responsibility to maintain a strong defense, especially now that prospects appear good for meaningful arms reduction talks. And we must not break faith with those poor and elderly who depend on Federal programs for their economic security.

The President proposes a FY 1987 budget with outlays of $994.0 billion and receipts of $850.4 billion. The budget proposals would thus hold the deficit to $143.6 billion -- $400 million below the Gramm-Rudman-Hollings target for FY 1987. On a current services basis, outlays are estimated to be $1,025.9 billion and receipts $844.1 billion, resulting in a deficit of $181.8 billion. This is what the deficit would be without Congressional action, and clearly it's too high.

In order to achieve the Gramm-Rudman-Hollings target, the President's budget proposes to reduce the FY 1987 deficit by $38.2 billion from the current service level. Of this amount, $6.3 billion comes from higher Government revenues. These receipts are a result of increased employee contributions to Federal retirement funds, initiatives by the Internal Revenue Service to collect more of the taxes already owed, and accepting the all-but-inevitable extension of the extra eight-cents-per-pack tax on cigarettes. An additional $3.2 billion comes from selling various real and financial assets. Increased user fees account for $2.4 billion in FY 1987, and reduction in the deficit will save some $1.2 billion in interest expense.

This leaves $25.1 billion to be derived from programmatic reductions from current service levels. Since $2.7 billion of this amount comes from reductions in defense funding -- while still preserving the three percent real program increase agreed to in the 1986 Congressional Budget Resolution -- only $22.4 billion of the $38.2 billion -- less than 60 percent -- must be obtained from cuts in domestic programs, defined as total outlays excluding interest on the debt, Social Security, and, of course, national defense.

Before anyone criticizes these proposed programmatic reductions, he or she should consider three important facts.

- First, the proposals, if enacted, would cut the current services base for these domestic programs by less than 5.4 percent. I repeat, programmatic cuts of less than 5.4 percent are all that are required to meet the FY 1987 Gramm-Rudman-Hollings target.

- Second, if these programmatic reductions are made in FY 1987, the future effect of these reductions, combined with the rest of the President's proposals and expected real economic growth, are large enough that we can meet all of the Gramm-Rudman-Hollings targets -- through FY 1991 -- without having to make any more programmatic cuts.

- Third, outlays for these domestic programs are estimated to increase by 10 percent between FY 1984 and FY 1986, even after taking into account the FY 1986 sequester and proposed rescissions. The point is that domestic spending has not been "cut to the bone" already as some have claimed.

The President's budget proposes to achieve the deficit reductions necessary to reach the Gramm-Rudman-Hollings targets by:

- Ending Federal activities that have outlived their usefulness;

- Transferring to State and local governments or the private sector those activities that they can carry out more efficiently;

- Reducing Government competition with the private sector;

- Modifying the operations of many other programs, including the better targeting of social services; and,

- Making the remaining Government programs more efficient, more effective, and more accountable.

Despite the very tight fiscal environment, this budget provides funds for maintaining -- and in some cases expanding -- high-priority programs in crucial areas of national interest. Services and income support for the dependent poor and the elderly receive substantial funding in this budget. So do other programs of national interest -- including drug enforcement, AIDS research, the space program, nonmilitary research, and national security.

Although national security programs continue to be one of the President's highest priorities, they have not been exempt from general budget stringency. Since 1984, the President has agreed to large reductions in his requests for defense budget authority:

- The Rose Garden agreement with Congress in May 1984 cut $55 billion from the President's proposed FY 1985 five-year plan.

- Congress then reduced the agreed-to Rose Garden level for FY 1985 by an additional $8 billion.

- In the FY 1986 budget, the Administration reduced the Rose Garden five-year levels by another $37 billion, due in part to revised pay and inflation assumptions.

- Last summer, the FY 1986 Budget Resolution compromise, which the President reluctantly agreed to, provided no real growth in FY 1986 and only three percent per year thereafter. This compromise yielded savings of $290 billion from the President's FY 1986 budget five-year plan.

- Congress actually cut 1986 appropriations $16 billion below the agreed-to level, including the effect of the Gramm-Rudman-Hollings sequester.

> Rather than the zero real growth agreed to in the Resolution, the 1986 level was reduced by about six percent in real terms -- not a pause but a two-year retreat.

The FY 1987 budget provides the same 1987 program level agreed to in the Budget Resolution compromise and three percent real growth in following years. However, the FY 1987 budget adjusts the Budget Resolution levels to reflect lower pay and inflation assumptions. These adjustments result in another $45 billion in savings for the five-year plan as compared to the Budget Resolution. Because of the six percent real decline in 1986, the proposed 1987 level does represent about eight percent real growth over 1986. Nevertheless, the President's FY 1987 proposed level for defense does not exceed the three percent real increase from the level that the Congress agreed to provide last August, and arguably is only a little over two percent higher in real terms than the actual 1985 level.

Some have questioned the FY 1987 estimate of national defense outlays included in the FY 1987 budget. I want to reaffirm that our estimate of $282.2 billion for FY 1987 national defense outlays represents our best judgment at this time.

Estimating outlays is a very complex task and depends not only on program composition and historical outlay rates but also on a variety of factors external to the defense program. It is also important to remember that, for each of the past several years, OMB actually overestimated defense outlays -- by $4 billion in 1983, $10 billion in 1984, and $2 billion in 1985. Our current estimates take into account and compensate for the causes of these recent overestimates.

As a benchmark, it should be noted that the budget estimates of defense outlays are higher than they would be if we had adopted as our starting point the assumptions in the 1986 Budget Resolution approved by Congress. This is true even though our projected outlays of $282.2 billion are less than those of the Resolution -- $285.2 billion. Let me explain.

The Resolution outlays were based on FY 1986 budget authority of $302.4 billion and a FY 1987 level of $323.4 billion. However, the final FY 1986 amount, after Congressional action on the Continuing Resolution and the 1986 Gramm-Rudman-Hollings sequester, is only $286.1 billion, or $16.3 billion less than the Resolution, and the proposed FY 1987 amount is $320.3 billion, or $3.1 billion less.

The FY 1987 outlay reductions resulting from these FY 1986 and FY 1987 budget authority reductions are about $8 billion. Given what actually happened, Resolution outlays would fall from $285.2 billion to $277.2 billion. Thus, if we had used the Resolution assumptions, our FY 1987 outlay estimates would have been $5 billion lower than the $282.2 billion figure contained in the President's budget.

Although we think that outlay rates will be somewhat higher than those assumed in the Resolution, they are likely to be lower than might have been estimated based on past experience. There are several reasons for this. For example, the effect of the continuing growth in the economy should shift corporate attention from defense to nondefense orders. Also, possible delays in deliveries might result from procurement reforms instituted by the Administration and legislated by Congress. And there are possible delays and uncertainties associated with the effects of Gramm-Rudman-Hollings. Each of these effects should lead to some reduction in outlays.

After taking into account all of the factors that I have mentioned, we continue to believe that the $282.2 billion outlay estimate contained in the FY 1987 budget is wholly realistic.

Accompanying this budget is the Administration's second report on management, the first signed by the President. The report describes the program that we call "Reform 88", which is this Administration's effort to upgrade the management of executive-branch agencies. It summarizes the progress we have made in the areas of cash management and debt collection, and outlines future steps we will be taking to improve the management of Federal loan portfolios. It describes efforts to upgrade agency financial systems for both improved efficiency and better control. Finally, it describes a comprehensive program which is expected to boost Federal productivity in selected Federal programs some 20 percent by 1992. This initiative should yield not only cost savings, but significant improvements in program delivery. In general, the report indicates that sound business practices can be brought to bear on Government programs and yield positive results.

In summary, the President's budget provides adequate funding for vital programs for the poor and elderly, for our Nation's defense, and for other high priority programs, and yet meets the FY 1987 Gramm-Rudman-Hollings deficit target without raising taxes. Moreover, the President's budget meets all the Gramm-Rudman-Hollings deficit targets through FY 1991 without increasing tax rates in any year.

Mr. Chairman, I recognize how difficult it will be to make some of these cuts I have outlined here today and that are detailed in the budget document. Strong special interest groups exist to lobby for almost every Government program, no matter how inefficient, outdated, or irrelevant to the average taxpayer. Moreover, countless repetitions of anecdotal horror stories and endless renditions focusing on specific cuts will create in the minds of many an image of the budget that is totally divorced from reality. The single fact is, that in exchange for a $3 billion cut in defense and $23 billion in cuts in domestic programs -- a nickel on the dollar -- we avoid both a FY 1987 sequester and additional cuts in later years. Is this really too much to ask?

The President's budget, through a combination of increased revenues, program terminations -- many of them long overdue --, spending cuts, and other reforms, meets the $144 billion deficit target for FY 1987. Any alternative approach would attack the family budget by increasing taxes, would weaken our national security posture, or would break faith with the poor and the elderly.

The President's approach, I submit, is in the long-term interest of the American people. Accordingly, I urge you give it a prompt and favorable response.

Mr. Chairman and Members of the Committee: that completes my statement. I shall be happy to address your questions.

The CHAIRMAN. Thank you very much, Mr. Miller.

I will ask the staff to move that easel so it will not interfere with the vision of those members sitting on that side of the hearing.

Let me begin, first of all, Mr. Miller, by going back to my original question. As I listen to your explanation and even as I have read your letter, I have some problems with your argument. You say that you have not underestimated the outlays as certified by CBO by $14 billion plus.

First, you point to the fact that in the past you have overestimated defense outlays, and you point to $4 billion in fiscal year 1983, $10 billion in 1984, $2 billion in fiscal year 1985. Well, if that is true—and I will say for argument's sake that is true—what happened this year? How can CBO say that the outlays are nearly $15 billion?

It seems to me that that fact, the fact you just gave before us and in your letter, bolsters our argument that something is wrong because it doesn't fit the pattern of the past.

Mr. MILLER. Good question, Mr. Chairman.

Let me say that for a very slow spending program like defense, or housing, for that matter, it is difficult to estimate outlays. If you have an agency that's 99 percent people, you can predict that outlays are going to be almost exactly the same as budget authority, but when you have slow spending accounts—weapon systems, construction projects, et cetera—it is hard to predict outlays. So that is No. 1.

Second, it means that if you have two experts predicting outlays, you probably are going to get two slightly different answers. It is almost inevitable that you get two slightly different answers, and I wouldn't immediately jump to the conclusion that one is right and one is wrong. We believe we are right, for the reasons I have just given. You will undoubtedly have an opportunity to question Mr. Penner, and he will probably explain why he thinks that his outlay estimates are right.

But again, the difference is that we in the executive branch control the outlays, and CBO does not. Frankly, to have overestimated outlays only by $4 billion, $10 billion and $2 billion is not a bad record. That is a better record than our estimating the deficit, for example, or CBO's estimating the deficit, for example, or the Budget Committee's estimating the deficit, for example.

You don't know for sure. It is a projection, it is a forecast, and you just do the best you can.

The CHAIRMAN. But there is a little difference this year. If we make a mistake on the best we can, we have something that's going to come back and hit us. My concern is could it be that maybe the higher CBO estimate of outlays in fiscal year 1986 is really—as well as fiscal year 1987, which you also confirmed in 1986, by the way, when you said that sequestration had to go into effect on March 1, so you and CBO did agree, at least for——

Mr. MILLER. We were very close on our estimate of the deficit for 1986. Astoundingly close.

The CHAIRMAN. Did you not agree with CBO that there was an underestimate of outlays for 1986?

Mr. MILLER. No. I don't have the document——

The CHAIRMAN. That's why the trigger was pulled for March 1?

Mr. MILLER. No, no; the trigger was pulled for March 1 because we both estimated the deficit in excess of $192 billion. As you recollect, under Gramm-Rudman, for fiscal year 1986 if the budget deficit exceeded the target by $20 billion the sequestration would be no more than $20 billion on an annual basis, or $11.7 billion——

The CHAIRMAN. I understand the technical reason why you pulled the trigger, but my point is when you realized we were over $192 billion, is it my understanding that you said part of the reason we were over $192 billion is: one, growth rate was not at what had been projected; two, there was an underestimation of the outlays spent in agriculture?

Mr. MILLER. Right.

The CHAIRMAN. We actually spent more in agriculture than we estimated on August 1 in the budget resolution. And third, we actually spent more in the Pentagon than estimated on August 1.

Mr. MILLER. Yes.

The CHAIRMAN. Now, that is what I remember reading in your report and CBO.

Mr. MILLER. Right.

The CHAIRMAN. So you have already said——

Mr. MILLER. I think we noted that the defense outlays were greater at that point than had been anticipated in the CBR, and that is what I just went over in my testimony. Our estimate is $5 billion above. Adjusting the CBR for the sequester, our estimate is $5 billion above what it would have been in the CBR.

The CHAIRMAN. In other words, in January you said, OMB and CBO both said we were spending in defense account faster than we had planned on August 1. This is one of the reasons we had to pull the trigger; we were over $192 billion.

Mr. MILLER. That spendout increase was very minor compared to the difference between $192 billion and $210 billion.

The CHAIRMAN. It was only $5 billion, but still, my point is that there was already a miscalculation.

Mr. MILLER. But Mr. Chairman, that is partly the reason that our estimates of outlays are $5 billion more than the CBR figure adjusted for the sequester and for the less than zero percent real growth in budget authority that the President agreed to.

The CHAIRMAN. Do you believe that the CBO reestimate of your defense outlays is based upon, in part, the $16 billion 3-year shortfall that you mention in your letter to me and in the testimony today?

Mr. MILLER. Well, conceivably I could say that since the outlays did not happen earlier, it is backed up in the pipeline and therefore it would be paid out in 1987, but——

The CHAIRMAN. Or it would be paid out sometime.

Mr. MILLER. It would be paid out sometime; right. The second point—and I haven't had a chance to talk to Mr. Penner directly about it, but some of my staff have talked to his staff—is that we were all aware of the slightly higher spendout rates over the last several months of the fall and spring than were anticipated. Their extrapolation, though, was for greater spendout in 1987. Their adjustment of the CBR was much greater than our adjustment, but we believe, again, that our adjustment is appropriate.

The CHAIRMAN. You also point out in your response that the current estimates take into account and compensate for any causes for recent overestimates. Now, when I looked at the Pentagon budget and at their financial summary tables which they submitted for fiscal year 1987, dated February 4, 1986, they show little, if any, change in the rates from fiscal year 1986 and prior budgets.

If the Pentagon, in their own financial summary, doesn't show a change in the spendout rate, what rates were used in preparing the fiscal year 1987 budget that causes such a difference between the Pentagon's financial summary and what you believe?

Mr. MILLER. I don't think there is any difference between the Pentagon's assumption and our assumption. There is a single budget, and the assumptions, the figures, the time path of outlays projected are exactly the same whether it's the formal documents printed by OMB under the title of the President's budget or the supplemental materials provided by the Department of Defense. To my knowledge, there is no inconsistency.

Of course, our people and the Defense people have discussed at great length the outlays and projections and time path of outlays. I don't believe there is any inconsistency.

The CHAIRMAN. Well, as I understand it, the Pentagon and CBO rates are just about the same, but apparently there is some difference between——

Mr. MILLER. I think there is a difference.

The CHAIRMAN. Well, they are very close. I guess what I am trying to get you to answer is, if the Pentagon's financial summary tables don't show anything as reflected in your testimony that makes for a compensation of overestimates in the past, what rates did you use to come up with the outlay estimates?

Mr. MILLER. Obviously, Mr. Chairman, I did not make these estimates myself. These were made by appointees of mine at OMB, and I simply do not know the great detail.

The CHAIRMAN. Could you give us a breakdown on the individual rates in writing later?

Mr. MILLER. Sure.

The CHAIRMAN. I wouldn't want to ask you for such a fine point, but I think that is very important because apparently something has happened. Let me just show you from a chart that I had my staff produce. This is a CBO reestimate of the President's defense budget: 1983, over $1.8 billion; 1984, under $0.5 billion; 1985, over $1.5 billion; and 1986, under $1.7 billion. And then all of a sudden, $14.7 billion.

Now obviously, the historical picture is not being followed. Something is wrong. And I'm not sure I have heard in the testimony what happened to cause this major kind of a change. Did you, perhaps, before you responded to me last week, ask CBO to give you their backup material as to why they—and what is your evaluation of it?

Mr. MILLER. Well keep in mind that we are talking about $14 billion out of $282 billion. Our estimate is $282 billion, and they would go $14 billion above that. So again, in estimates and the way you estimate that sort of figure, that is not that big a difference. It is a $14 billion difference, but in terms of estimating technique, you can only do what you can do.

The CHAIRMAN. I understand what you are saying, Mr. Miller, but my only concern is twofold. One, the President announced to the Nation that this budget meets Gramm-Rudman, $144 billion. According to the new budget act, the Emergency Deficit Control Act of 1985, called Gramm-Rudman, we have to meet that $144 billion.

Now, if the President hasn't met it, why should the Congress be required to meet it? We all ought to start playing on the same ground. And that's really what my question is.

No 2, and even more importantly because if there has been a mistake in the estimates, we can redo them and you can get them back to us. The question I have is, as chairman of the House Budget Committee I must ask Members of the House to vote for a budget which I am going to be saying is equal to the law, $144 billion. And if I mislead them because of technical imperfections—and as Congresswoman Martin said, we do use the President's prescription as a basis for discussion—then what is going to happen is that in August you and Dr. Penner are going to take a snapshot and say, whoops, you didn't hit $144 billion, it's $164 billion.

Then at that point, we have about 45 days to find additional cuts or to come up with some way to solve the problem. That's why this year I think it's a little bit different than past years. Also, this is why I cannot buy the argument of saying, well, it's only a small difference in a small estimate.

I just wondered if you had talked with CBO since the——

Mr. MILLER. Let me say several things. One, I will be using the same camera to take my snapshot with next fall that I used in taking this snapshot. Second, I did get someone to call CBO, and what we got was a preliminary printout of their estimates, without the rationale. Then we had to go back and get the rationale.

Bear in mind that while there were differences on the defense number, there were differences between OMB's and CBO's estimates on a lot of the assumptions.

For example, we assume that revenue sharing in our baseline has been eliminated. In coming up with the $182 billion, we assume that revenue sharing, which expires by legislation, is not there. CBO, I understand, assumes that general revenue sharing is continued. That is some $4 billion or so. So this would mean that on that basis, CBO overestimated the current services deficit by $4 billion.

When you wash through all these things, the question is what is their bottom line deficit going to be. So, Mr. Chairman, I don't think you can really say that, well, because CBO differs with you on estimating this particular account, this means that you have underestimated the amount of savings that you must have. I think you have to look at what the bottom line CBO numbers are.

And second, you assume that CBO is correct and we are wrong, and for reasons I have given you, I think it is quite the other way around.

The CHAIRMAN. I guess my problem is that CBO has said it, and Senator Domenici has said it on national television. Both state there is a serious underestimation problem, and my staff also came to this conclusion. So I guess it is three to one, and I think something is wrong and it ought to be addressed. Could it be that your

problem is that you are using the outdated figures of the congressional budget resolution of August 1? You keep referring to "a deal" made between the President and the Congress on defense spending, when everyone knows that $302.5 billion is a ceiling. Mr. Weinberger actually receives what is appropriated, and what was appropriated was not $302.5 billion but something significantly less, around $287 billion.

So therefore, maybe your mistake is that in putting together the President's budget, you were using the outdated figures of the old budget resolution as part of the deal, when you need to use the updated, latest economic indicators which you in January, as well as OMB, utilized in order to order sequestration for March 1.

You might want to take a look at that because I don't think anybody wants to use those outdated figures of August 1.

Mr. MILLER. Well, the President does believe that he struck a deal. He truly believes that the nature of the agreement was that in exchange for his going along, he was going to get that defense spending. But to be fair, if you started with the $286 billion—which reflects the sequester because $297.5 billion was, I think, appropriated in the CR—then you have to look at what the CBO's figures are on that basis.

And on that basis, they estimate the current services deficit lower than what we estimate. They estimate, I understand, the current services deficit at $178 billion rather than $182 billion.

The real question, Mr. Chairman, is if you adopt the President's budget, how much spending will there be and how much revenue will there be. On the spending side, we have amounts indicated for each account. There are requested budget authority and estimated outlays for every account in this budget, and for the entitlement programs as well.

So the relevant question for estimating the deficit is not so much what the congressional budget resolution had but what these figures show, and I think these figures, appropriately appraised, will suggest that the deficit will be $144 billion.

But again, if you think that the deficit under this budget is going to be higher, I am sure that we would be more than happy to respond to any particular suggestions you have for closing the deficit further.

The CHAIRMAN. Before I yield to my colleague here, the House of Representatives, as well as the Senate, will come up with a budget that will respond to the needs of the Nation. But I don't think it's very responsible for the President to submit a budget which—you have so many independent agencies, as well as people in the Senate raising questions about whether it meets the $144 billion target. It seems to me that it is also incumbent upon the President to look at that and come back and resubmit it and make the additional $14.7 billion in reductions.

Now he has two ways to do it. He can do it by cuts, or he can do it by more privatizations. But some way, he's got to do it. Otherwise, it is really submitting a budget that is not a budget, after telling the American people in the State of the Union that, "I have met and complied with the law."

Mr. MILLER. Well, we just have a difference of opinion, Mr. Chairman.

The CHAIRMAN. It's a major difference of opinion, then, Mr. Miller, and I would hope that you would again go back and look at it, because it's not minor, it's major. You're talking about billions of dollars, and more importantly, you're talking about a new budget process that dictates accuracy. So I would just hope that you will take another look at it, ask CBO for their backup, and compare it.

Mr. MILLER. Well, could I just make one comment? I hope that you will ask CBO and be as critical of them for their propensity to overestimate outlays, as you have queried me about our perceptions.

The CHAIRMAN. I'm going to be just as critical for that same reason, because if they're wrong on the domestic side, the slingshot comes back and hits us; Gramm-Rudman comes and bites it. And the sequester comes riding out of the East, the West, the North, and the South. So I want them to be right on housing. I want them to be right on the Pentagon. I want them to be right on Medicare. I want them to be right on everything because no longer can we afford the luxury, as we have in the past. I'm familiar with the process. We've always taken a guesstimate.

I'm just simply saying that this year, we can't take guesstimates. We've got a law that says, "You must hit a total deficit of $144 billion."

Mr. MILLER. Right.

The CHAIRMAN. Now the President ought to meet that. The Congress has got to meet it. And if we start off fudging the figures, or not fudging them, but just for some reason having a miscalculation——

Mr. MILLER. Well, the first point I will make in reiteration is that two experts can disagree on what the projections would be. This is inherently a forecast. You don't know with absolute certainty.

The second point is that to the degree you could know, certainly we would know, since we control them.

The third point I want to make, Mr. Chairman, you're absolutely right that we need to do the best job we can. Under the sequester provision for 1987, let's suppose that the Congress adopts the President's budget in total, and as a result of this, in August, OMB comes up and estimates the deficit as being $143.6 billion, and CBO comes up and estimates the deficit as being more. As I indicated to you, I suspect that the difference in the deficit estimate will be less than $15 billion. But let's suppose that they estimated it being $15 billion more than we did. If you average the two numbers, you get $7.5 billion. And as you know, under Gramm-Rudman for 1987, there would not be a triggering of the sequester because you have to have the deficit estimate exceed the target by $10 billion in order to trigger the sequester.

The CHAIRMAN. Thank you.

[The following information was supplied for the record:]

SPEND-OUT RATES OF OUTLAYS IN DEFENSE

The outlay rates in Defense's Financial Summary Table, for the fiscal year 1987 Budget (shown at Tab M in the Financial Summary Tables) reflect historical experi-

ence, however, our estimate of 1987 defense outlays assumes that spending will slow down in the coming years for the following reasons:

Increased economic growth. The upturn in the economy from 2.5 percent real growth in 1985 to an estimated 4 percent in 1986 and 1987 should shift private sector attention from Defense to nondefense orders and thereby slow Defense outlays.

Procurement reforms. The reforms instituted by the administration and legislated by Congress should slow down contract awards.

Reduced progress payments. The reduction in progress payments from 90 percent to 80 percent made in April 1985 should have greatest effect in 1986 and 1987. This is because procurement appropriations have large second and third year spend-out rates.

Program composition. The shift in the composition of procurement from major systems to support equipment should result in slower rates for procurement spending.

Most—in fact, more than 90 percent—of the difference between Defense's and CBO's estimates of Defense spending in fiscal year 1987 is in the two areas that are affected most by these factors—procurement and research, development, testing, and evaluation.

The CHAIRMAN. The gentleman from Pennsylvania, Mr. Goodling.

Mr. GOODLING. Thank you, Mr. Chairman.

I sympathize with you, Mr. Director, when it comes to estimating. I've been in this Congress for 12 years, and I think the term the chairman used, "fudging figures," for Congress is pretty accurate. In committee after committee, we knew very well when we were indicating amounts, that we weren't going to nearly cover what it was that we were actually going to spend, and, as a matter of fact, I've sat through supplemental after supplemental after supplemental, some coming about because of economic conditions, but more times than not, from Congress' ability to fudge originally. Also, I've seen continuing resolution after continuing resolution, which I originally thought meant that you're going to continue to spend the same amount that you spent the year before, but I've discovered that that means, anything you want to throw into the pot and sneak it through is what goes in there.

My concern is that your estimates are going to be off, not because you estimate according to what you say in the budget, but that you're going to be off because, for instance, you talk about base closings. How successful have you been in relationship to the Congress of the United States when it comes to base closings?

Disposing of surplus properties, how successful has the administration been? Major domestic policy changes are part of your estimate. How successful has the administration been? And then, of course, you have some rescissions that perhaps you've included in here. If not, if we accepted some of them, it would make it easier.

So my concern is, how reliable do you believe your estimates are, considering the past history of doing all those kinds of things that you say you'd like to do in your budget, and if you think the chances are better, why do you think they're better?

Mr. MILLER. Mr. Goodling, I think, first of all, of course, the estimate of the deficit is an estimate. It includes the $38.2 billion in cuts or in savings are contained in the budget. And I guess you're asking, why do I think that we will be successful in getting Congress to agree to many of these, given the track record?

I guess a couple of things. One is, a salesman doesn't quit calling just because he doesn't make a sale. I truly believe that the pro-

grams that we've asked to have changed this year deserve to be changed on the merits, especially in a frugal environment.

The second point I would make is that it's a different ballgame. It's a different institutional arrangement. It's Gramm-Rudman-Hollings. We have to make those tough choices. If it's not cutting this, it's cutting something else. If it's not this user charge, it's another user charge. If it's not this asset sale, it's another asset sale.

So I think in a way that never before, the Congress—and the President, too—have to make hard choices. The President made hard choices in the budget he's proposed. Congress has to make hard choices in their response to the President's budget. No longer is there a barrel of red ink. There's a little vial that says $144 billion for 1987. That's all the red ink there is. So the rules of the game are different.

Mr. GOODLING. One other question. I noticed recently that there seemed to be a lot of figures that keep changing as to the size of the deficit and the amount of the income, et cetera. Do you see changes in your projections now, since it was originally put together, and for what reasons?

Mr. MILLER. There is always that danger, in the same sense that the chairman used it. You know, the economy might be less well than we thought it would be come August. It might be more robust. If anything, the economy has increased its vitality—since we chose the parameters on which this budget is based. That would affect revenues as well as expenses.

The recent oil price drop is greater than we anticipated its being. That has some effect, not a dramatic effect, on the budget deficit. Because of the reduced price, the agencies would have to pay less for oil, but there's the reduction in the royalties that we get from the sale of oil as well.

The secondary effect is that the economy will probably grow a lot faster because of this reduction in oil prices.

So what we have had since the parameters were established for the budget is evidence on two fronts that give us reason to believe that the economy might well grow faster and that the budget deficit, if anything, might be less than what we predicted. But it could happen that the conditions by then would change, and so our estimate would say that there's a greater danger that the deficit would be higher.

Mr. GOODLING. I have no other questions.

The CHAIRMAN. The majority leader of the House of Representatives, Mr. Wright.

Mr. WRIGHT. Mr. Miller, I don't want to prolong the discussion needlessly regarding discrepancies in budget assumptions, particularly with reference to military spending. I just would like to make this observation, and then I want to go on to another area.

That is that we aren't talking—the chairman wasn't referring to minor technical differences between assumptions on the part of the OMB and the CBO. We're talking about a $14.7 billion discrepancy, and that's big. And we really do think that that needs to be recognized.

What you say undoubtedly is true, that the bottom line is how much we actually spend, and you're asking us to spend $44 billion more in military spending, Pentagon spending, next year than

we're spending this year. And that shouldn't be referred to as a $3 billion savings in defense. It shouldn't be referred to as a reduction in defense funding. It's a $34 billion increase over the current spending level, and that amounts to something like a 12 percent increase or about an 8.4 percent real increase.

At the same time, you're asking us to raise space spending by $2 billion. You're asking us to raise foreign aid spending by something like one-half billion dollars and various other things.

Those are the things that count, but this is a big subject, and when you say that we're under the President's military spending request cumulatively by $182 billion, we had a $220 billion deficit, and I wonder what the deficit would be if we had given him everything he asked for in Pentagon spending. You know, these things are big; they're not minor.

But I do want to ask something that's minor as far as the budget is concerned, but big so far as people are concerned, and that has to do with the proposed user fees for people who want to buy and own homes. We have tried to make it easier and easier in this country for more and more people, people of moderate circumstances, to own homes. We thought that was good for the country. And now you're trying to turn that around, it seems.

The President said in his state of the Union message that, "It's time we cut the Federal budget and left the family budget alone," and that was a nice piece of rhetoric, and I guess everybody more or less agrees with it. He has repeatedly said he would shoot down any attempt to increase people's taxes, and you have reiterated here today that your budget doesn't have any increase in taxes.

But let's look at what it does. It proposes that we hit the family budget and increase fees, if you want to distinguish them from taxes. Anybody that needs to buy a home, using the Federal loan guarantees under FNMA, GNMA, FHA, VA, according to the figures I have by the Budget Committee staff, the plan that's encompassed in the budget would require a purchaser under FNMA or GNMA or a VA insured mortgage, to pay about $30 a month more on the average for the life of that mortgage or about $10,000, maybe, over the life of the mortgage. It would add that much to the cost of a home, and he wouldn't get anything for it.

If that's not a little tax or an attachment on a family budget, I don't know what it is.

Under the FHA plan, you'd pay more up front, increasing from 2.5 percent to about 5 percent of the loan that he'd have to come up with, he or she, the family. If that's a $200,000 loan, that's $10,000 more that they'd have to put out right up front, adding to the cost of the home.

If that's not a tax, I don't know what you call it.

Now Chase Econometrics estimates that these user fees would result in 100,000 fewer housing starts per year, 60,000 fewer new home sales, 175,000 fewer jobs in the housing industry. And yet it would just yield a relatively small amount. If you think $14.7 billion is small, this would be super-small.

Now I've just got three questions. First, don't you recognize that user fees of this type are really a sort of housing tax? It's not distinguishable from a tax, if you make people pay it. It's a hidden tax that they'd have to pay for the privilege of borrowing money to

buy a home, and it will be a hit on the budget of the average American family.

Second, from a social standpoint, wouldn't you agree that it's good for America to promote homeownership, and that anything we do to make it harder destroys a part of the American dream?

And third, have you considered the wider impact on the housing industry, on the overall economy? Do you think it would be healthy for the economy to reduce the number of housing starts and the number of jobs in the housing-related professions?

Mr. MILLER. Let me respond, Mr. Leader, by saying, one—I'm reluctant to call a tax something that is a reduction in a subsidy or that represents the needed price to make a program that the Government has set up financially sound. So I guess we just have a problem of semantics there, I guess a disagreement.

Mr. WRIGHT. From the standpoint of a family buying a home, it's scarcely distinguishable.

Mr. MILLER. Well, it's an increase in cost to them. Homeownership is a good thing, and we have considered the wider impact, although I have not had a review of the Chase Econometric study.

The President remains committed to making housing more affordable by pursuing economic policies that continue to bring down inflation and interest rates. First, as a result of his policies, more families can afford homes today than at any time since 1978. Today nearly half of all American families can afford the median price existing home because of lower mortgage interest rates and improved real incomes, not Government programs.

Second, the proposals in the 1987 budget aim at expanding homeownership opportunities for even more Americans. The proposals would limit FHA eligibility, merely target assistance to those families in the greatest need for Federal housing assistance. The FHA Insurance Program is used by many affluent households, as well as those with lower incomes. The budget would target those to families with incomes of $40,000 or less, compared to the median national income for a family of $26,000.

The proposals to raise the fees for the FHA mortgage insurance and VA Home Loan Guarantee Program are necessary because of high recent default rates. In an insurance program, these premiums have to cover the cost of losses. And the proposals to impose fees on Federal and federally sponsored credit agencies servicing the housing industry are intended to reimburse the Federal Government for the indirect subsidies that they enjoy, to better reflect sound principles, I think.

The CHAIRMAN. The gentleman from Florida, Mr. MacKay.

Mr. MACKAY. Mr. Miller, you come to this committee after we have learned for several years under your predecessor, Mr. Stockman. I almost feel at times as if I understand what you are saying, and it makes me nervous.

I would like to just talk about one aspect of some of the problems we have had. Last year a number of us questioned your predecessor about the assumptions in his budget, which, it seemed to us, were unduly optimistic. They were much more optimistic than the private sector forecasts.

We decided to go ahead last year, and I think that is one of the primary reasons that we ended up with a deficit that was $30 bil-

lion higher than we had projected, although we did essentially what your predecessor had recommended in terms of aggregates.

Now, this year under the Gramm-Rudman procedure there is quite a disincentive for going off with a rosy, unrealistic set of projections at the outset because if we are not right, it is going to come back and grab us in August. And yet when I look at your projections as contrasted with, say, an average of Chase, DRI, and Wharton, once again you seem to be much more optimistic than they are, which, it seems to me, is sending us off on the same kind of beginning that we started off with last year.

It seems to me that your GNP growth projection is substantially higher, your CPI increase lower, your unemployment rate projection is lower, your interest rate projection is substantially lower. Now, what would be wrong with our just accepting their projections, and what would it do to your budget if we did that?

Mr. MILLER. Well, could I just respond in a generic fashion first to the propensity of the administration to have had estimates too high. Keep in mind that some years our estimates turned out to be too high and sometimes they turned out to be too low. As a generic matter, the estimate that you have is based on the assumption that Congress endorses the budget.

If Congress does not endorse this budget, you are right, we may find that the rate of growth will be lower. If the Congress does not do something specifically about the deficit, I have no doubt that the rate of growth would be lower and the rate of interest would be higher.

Mr. MACKAY. Are you suggesting that that happened last year?

Mr. MILLER. I am suggesting that there is a tendency for that to happen, yes. It is not just the aggregates. It is also the division of how these programs—let me just say——

Mr. MACKAY. Are you suggesting that it will grow faster if we increase defense faster and cut the other part lower as compared to cutting defense more and increasing the other part more? In other words, is it the bottom line that counts or is it the way we do it?

Mr. MILLER. I think the way we do it counts as well.

Mr. MACKAY. I see. All right.

Mr. MILLER. Could I go on to point out, in response, I do not have before me the specific numbers, but we do have in our budget a page 2-29 which shows the results of our sensitivity analysis and would indicate what would happen to the deficit if you had changes in assumptions.

Mr. Chairman, did you indicate you thought a 1 percent increase in unemployment would add $20 billion to the deficit? Did you say that in your opening statement?

The CHAIRMAN. I may have mentioned that it could add higher than that.

Mr. MILLER. Higher than that? That is in excess of what our sensitivity analysis shows on that.

The CHAIRMAN. What does your analysis show?

Mr. MILLER. A 1 percent higher unemployment rate would increase the deficit for 1987 by, it looks like, $6.5 billion.

The CHAIRMAN. If unemployment went up 1 percent, it would increase the deficit by $6.1 billion?

Mr. MILLER. Right.

The CHAIRMAN. That is an interesting figure. That's the lowest one I have ever heard for a 1 percent increase in unemployment. Does that include not only lost revenues but also payments that have to be made?

Mr. MILLER. It appears that these are the outlay effects, unemployment benefits, and other employment-sensitive outlays.

The CHAIRMAN. I think maybe we need to take a look at that figure, too, but let's do it a little later.

Mr. MILLER. OK.

Mr. MACKAY. I just want to ask this one other question. I have read some news commentary that seemed to indicate that now that Mr. Stockman is gone, the doom and gloom days are behind us; that our attitude is now different; that we now think the deficit, if nobody does anything, is just going to go down. Is that an accurate characterization of your approach as contrasted to Mr. Stockman's?

Mr. MILLER. Well, I don't want to contrast my approach with Mr. Stockman's. I would just say I'm doing the best I can to present you with what we think are our best estimates of the major parameters that affect the budget. We also present the budget details consistent with or following the President's priorities, as he has articulated them in some detail to us and in general publicly and also privately, no doubt, to many Members of Congress and the Senate.

Mr. MACKAY. Thank you.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Mr. Miller, I would like to follow through a little bit on the questions and assumptions but from, I guess, precisely the opposite point of view as Mr. MacKay did. The New York Times today, I believe, had a story that indicates that most of those private sector firms that have been estimating more pessimistic scenarios than the administration are right now in the process of redoing their own assumptions and, in fact, suggests that many of them might come up with assumptions about economic growth for the coming year that are more optimistic than the administration.

My question is this, and I don't want a whole lot of detail, but can you give us some idea, similar to your answer on the unemployment question, what does an additional one-half percent growth rate, for instance, in your budget do in terms of the deficit? What would an additional 1-percent fall in interest rates do to the deficit if, indeed, those favorable assumptions that are suggested in some quarters are forthcoming?

Mr. MILLER. A 1 percent lower rate of real growth beginning in October 1986 would have a $6.2 billion effect on Government receipts, and since it is probably reasonably symmetrical at that point, a one-half percent higher rate of real growth would probably have about a $3.1 billion reduction in the deficit.

Mr. WEBER. I see. And following that through for just another second, the major reason they suggest for the reestimates would be falling oil prices. When you put together your estimates in economic growth, what did you project in terms of oil prices?

Mr. MILLER. If you want to go ahead with another question, I will be looking for that.

Mr. WEBER. My next question refers back to a point that our colleague from Pennsylvania, Mr. Goodling, made. If we look for addi-

tional savings in the administration's defense budget, many of us would like to do so in a way that is minimally disruptive of our national security needs. In the 1986 defense authorization, Congress made it more difficult to close bases.

If we were to undo some of those things, make it easier to close bases, how much money do you think we might be able to save, and could you prepare for the committee a list of bases that could be closed without any impact on our national security needs?

Mr. MILLER. I think I could provide you, working in cooperation with the Secretary of Defense, a list of bases that could be closed and the savings attendant with those closings.

Mr. WEBER. Do you have any idea how many dollars we are looking at there?

Mr. MILLER. I don't know. The savings would not be so immediate because there are certain transition costs. The bigger savings would occur in 1988. We are talking about several billion dollars, I think, by the time you dispose of the assets.

I understand that we had something on the order of $25 a barrel as our assumption on oil.

Mr. WEBER. And on that, you assume 4 percent growth.

Mr. MILLER. Yes.

Mr. WEBER. Finally, I have a question that is tremendously important to my part of the country. The administration has proposed selling off the Power Marketing Administrations. I think the concept of privatization has a lot of support in the Congress, but you suggested that one of the goals of privatization is to give equal service at equal or lower costs. Every estimate that I have seen says that selling off the PMA's would result in dramatic increases in cost and decreases in service to their customers. What is the rationale for doing that?

Mr. MILLER. I think on the whole, the PMAs' customers would pay some increases in rates, but they are already being subsidized rather substantially because of the lines of credit from the Federal Government and the low repayment schedules. If you raise payments in some of these areas, you might more approach the costs that other taxpayers are paying.

Mr. WEBER. I just want to point out that the increase to many families would be as much as $100 a month, so we are not talking about a small or negligible increase in costs to the user. I understand the economic rationale you are putting forward; all I would say is it does not square with the rationale the administration has presented saying that we can—which I believe we can do in many cases—provide equal service at equal or lower costs. In this case we would provide service at substantially higher cost.

Mr. MILLER. Oh, I see your point. No, you are right. Your point is correct.

Mr. WEBER. Thank you, Mr. Chairman.

The CHAIRMAN. The Chair recognizes the gentleman from Michigan, Mr. Wolpe.

Mr. WOLPE. Thank you very much, Mr. Chairman.

Mr. Miller, I am convinced that all Members of the Congress sincerely want to meet the fiscal year 1987 deficit limit of $144 billion. It is no longer a question of commitment; it is a matter of mandat-

ed law that both the administration and the Congress are obligated to achieve.

The budget that the President has proposed to meet this goal attempts to do so with very deep cuts in the programs that I think most of us on this committee would probably, on a bipartisan basis, argue are pretty vital to the future economic strength of our country. For example, the cuts in higher education, the cuts in job training, the cuts in community development programs.

In light of these extraordinarily severe cuts in enormously worthwhile programs, I would like to receive some clarification from you of the administration's position on what has got to be the greatest example of boondoggle, wasteful spending that we have had in the Federal budget for years. I am talking about the Synthetic Fuel Corporation.

I would be interested in the administration's position on the Corporation's last minute decision in direct defiance of the action by the Congress to give hundreds of millions of dollars in Federal subsidies to Union Oil Co.

I have before me a letter that you sent to Senator Hatfield on December 12, 1985, indicating the administration opposed any further spending by the Synthetic Fuels Corporation. I also have before me a letter dated just 1 week later, December 19, stating that it was OK now, from your standpoint, for the SFC to go ahead and spend huge sums of money.

Mr. Miller, how can you propose to make the kinds of cuts you are asking for in higher education of 25 percent while supporting $67 per barrel subsidies to Union Oil Co., particularly with oil prices close to $15 per barrel?

Mr. MILLER. Well, Congressman, let me say that the President signed the CR and supported the zeroing out of Synthetic Fuel Corporation. The question was whether in the case of these particular projects—Parachute Creek and Seep Ridge—there had been bona fide commitments made on those two issues of a legal nature.

We were apprised that there had been commitments made in the case of Parachute Creek and I don't want to——

Mr. WOLPE. Mr. Miller, if I may just interject here, that argument was advanced months in advance of your first letter in which you called for the ending of funding for those projects and all others. The argument has no validity. The only commitments that had ever been extended in a legal, formal fashion related to Union Oil Shale 1, the Union Oil phase 1 of the project, which they have never yet been able to get to work. There were no obligations with respect to Union phase 2, which is what the new obligations were extended for.

Mr. MILLER. Fortunately, I guess fortunately, for us both, I think that whether there was such an obligation commitment made or was not will be answered in the courts. My perception is that it will be litigated.

Mr. WOLPE. Well, some of us have some difficulty understanding the depth of the administration's commitment to elimination of waste when it affects some elements of the corporate constituency of the President when he is so free at discarding other programs that have pretty significant importance for a lot of people.

Mr. MILLER. As you know, we did support eliminating the Synthetic Fuels Corporation. The question is whether there were two projects that had been committed or had not been committed. That is the only question. We proposed zeroing out.

Mr. WOLPE. Let me ask you an economic question. You also call in the budget for the sale of the naval petroleum reserves. In other words, we would sell the naval petroleum reserves. Right now when the price of oil sells for some $15 per barrel, do you think it makes any sense to buy Synfuel designed for jet fuel purposes at some $62 a barrel and then sell the oil that we have for $15 a barrel? Is that good economic planning?

Mr. MILLER. Just to repeat, the administration encouraged Congress to close down the Synthetic Fuels Corporation. The only question is whether we had a legal obligation for those two issues, and that will be resolved in the courts.

Mr. WOLPE. The fact of the matter is had your letter not gone forward, the Synfuels Corporation would not have extended this additional obligation. That's the fact.

Mr. MILLER. No, no; my understanding is that there had been a commitment. I was apprised subsequent to my first letter that the commitment had been made.

Mr. WOLPE. Let me ask just one last point, if I may, Mr. Chairman. That relates to the subject of the deal that you keep referring to, that the President believed he had a deal. Did the President not sign the Defense appropriations bill, did the President not sign the Gramm-Rudman Budget Act, both of which in combination yielded a much lower defense number? Was he not part of that deal or that arrangement, as well?

Mr. MILLER. No, obviously he did sign those, but he did not——

Mr. WOLPE. Then why do you keep referring to an earlier deal when he, himself, participated in a subsequent decision that essentially eliminated the original understandings?

Mr. MILLER. Well, we could get in to a semantic discussion as to whether his signing a continuing resolution that contained a certain amount for defense that was less than what he had bargained for was tantamount to his express willingness to completely do away with the earlier contract or simply reflected that the contract had not been met.

As you know, since it was the fifth continuing resolution, we were faced in this period just before December with the closedown of the Federal Government or a significant portion of it, and also we came very close to defaulting on Government loans. So it was not an easy time.

Mr. WOLPE. I'm sure it was not easy for the President, nor was it for the Congress, but we both understood we had to meet the lower target rather than the higher, and I think it should be clear that any budgeting from this point on ought to take that as the relevant point of reference. Thank you.

The CHAIRMAN. The gentleman from Massachusetts, Mr. Atkins.

Mr. ATKINS. You recommend in your budget an increase in the IRS of 2,500 agents and correspondingly assume an increase in revenues for this year of $900 million and of $7 billion over a 3-year period. I'm wondering, in light of the $100 billion tax gap that the IRS estimates now—that is, the revenues owed the Government

but uncollected—why you didn't give consideration to going further in the area of revenue enforcement as a mechanism of trying to achieve further deficit reduction in this budget?

Mr. MILLER. We did. One thing we decided not to do was to make substantial changes in enforcement policy in the budget. We are looking at this issue in our ongoing study of the tax system, how much additional Government revenue is collected per agent and that sort of thing.

Mr. ATKINS. That study is undergoing now?

Mr. MILLER. Right.

Mr. ATKINS. When do you expect the results from that study?

Mr. MILLER. I'll have to get back to you on the details.

[The following information was supplied for the record:]

STUDY ON REVENUE ENFORCEMENT

The Administration recognizes the important revenue-generating role of the Internal Revenue Service. The Office of Management and Budget, the Department of the Treasury, and the Internal Revenue Service are looking together on an ongoing study (which involves a sophisticated computer model) regarding the costs of providing additional resources to IRS and the additional tax revenues to be gained as a result.

In fact, two IRS initiatives incorporated into the 1987 budget are a direct result of this study. The two initiatives in the 1987 budget include: (1) a revenue initiative which will add 2,500 auditors per year for the next 3 years—the objective is to raise over $10 billion by 1991 in taxes currently owed but not being paid; and (2) a tax shelter initiative which will accelerate litigation of questionable shelter schemes and is estimated to accelerate collection of nearly $600 million in back taxes.

Mr. ATKINS. Wouldn't it make sense, in light of the 18 States that have had just fantastic success with various types of revenue enforcement programs, some including tax amnesty, some not, to have a more comprehensive program of tax enforcement and see if we can't get that figure up significantly?

Mr. MILLER. That proposal is at issue, and we may be able to look at that in our study.

Mr. ATKINS. I understand. I'm just concerned that if this study comes out a year from now, it will be too late for us to use what I think, given the experience of 18 other States, would be a favorable recommendation for more agents, more enforcement, and more publicity around an enforcement effort and perhaps even a tax amnesty.

Is there any possibility that you could come in prior to our decisions on a budget resolution with some recommendations there for additional revenue?

Mr. MILLER. I will discuss that with the Secretary of the Treasury. I don't think, though, that for fiscal year 1987 we would suggest any changes in the resources devoted there.

We are in the process of trying to manage them better. Mr. Egger and, of course, Mr. Baker are all concerned about not having some of the problems that we had last year, and the returns being crammed into bathrooms and that sort of thing, and that's one of the things that we have tried to deal with in this budget.

Mr. ATKINS. It just would seem, if you feel conservatively, that you can estimate $900 million in additional revenues from 2,500 new agents, why it wouldn't make sense, for instance, just to go up to 5,000 new agents, and certainly your math—and while one could

assume that the amount of additional revenue collected by each agent declines by some factor as you increase the number of agents, that you still would have a very, very favorable ratio there, particularly in light of the fact that tax compliance is now down to record lows, and you do have that $100 billion tax gap.

Mr. MILLER. We will look at it again. We looked at it this time and concluded that this was the appropriate amount.

But I see your reasoning. The study that we're undertaking, I think, is going to answer a lot of questions.

Mr. ATKINS. OK. Let me ask you one other question, if I could, and that is on your monetary assumptions underlying your economic assumptions. What did you assume for monetary policy that would be promulgated by the Fed?

Mr. MILLER. We assumed—as you know, as you go from M1 to M2 to M3, the Fed looks better in the sense of meeting monetary aggregate targets. M1, they've been consistently above, I think, reasonable targets for money growth. They've been around 11 or 12 percent over the past 18 months or so, although the money supply varies quite radically.

Mr. ATKINS. What did you assume for Fed behavior?

Mr. MILLER. What we assumed for Fed behavior is that they would slow down the rate of growth in the money supply. I think it would be a terrible mistake to step on the brakes, and come to a screeching halt in the rate of growth of the money supply. The Fed should gradually taper down the rate of growth in the money supply.

Mr. ATKINS. If that's the behavior that you project for the Fed, wouldn't it then be the case that the Fed would have to be assuming that Congress would not achieve the $144 billion Gramm-Rudman target in promulgating that policy?

Mr. MILLER. No; I don't think there's anything, Congressman, inconsistent with the Fed's slowing the rate of growth of the money supply and Congress' achieving the $144 billion target.

We do include in there a slight tick-up in our inflation estimates, the GNP deflator estimate, because there has been rather inordinately rapid growth in the money supply in the last year or so. As you know, you tend to see the increased growth of the money supply appear in inflation, in rising prices, 1 year or 18 months, sometimes 2 years later. It's a lag relationship.

The CHAIRMAN. The Chair recognizes the gentleman, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Miller, I want to congratulate you on meeting the $144 billion target. Obviously, there are many who will fuss about the assumptions, myself included, but I think it's an achievement, and I am a bit surprised to hear from folks who have not proposed anything themselves to criticize but not come up with any alternatives. So I appreciate your coming here today and your making a policy proposal.

I'd like to shift areas a little bit and ask in some areas where we could cut or where we might cut. But I had one question about your presentation that I'd like to go back to.

The chart that we saw indicated a drop in defense spending from 1985 to 1986. But as I look at the numbers, defense spending went up over $13.1 billion from 1985 to 1986. How could the chart have

shown a drop rather than an increase? Now I'm dealing with outlays.

Mr. MILLER. It may be the difference in budget authority now.

Mr. BROWN. It might have been authority.

Mr. MILLER. Right.

Mr. BROWN. Thank you. Drawing your attention to our relationship with Japan, my understanding is that they spend a little less than 1 percent of their GNP on defense. We spend a little less than 6.5 percent of ours on defense. What are your thoughts about requiring them to provide a little bigger share of the defense burden, take on themselves, rather than us continue to provide those military services for them?

Mr. MILLER. Well, let me put in the caveat that I'm not an expert on foreign policy, and I will reserve judgment on that or defer to the experts, the Secretary of State and the Secretary of Defense.

I think as a general proposition it makes sense where we can, for our allies to carry a good load of the burden of our collective security.

Mr. BROWN. My hope is that the administration might give a close look at that, as I know you are on a lot of things.

We have about a third of a million troops in Europe right now. The folks on the Armed Services Committee tell me it costs substantially more to have a soldier in Europe than it does in the United States. Has the administration given any thought to reducing the number of troops in Europe as a way of saving funds?

Mr. MILLER. We have done that, but with in the context of the needs for our national security, we decided that the figures that are in the budget are the appropriate ones.

Mr. BROWN. My friend, Congressman Smith, tells me that the Defense Department has 160,000 or more civilian employees now than it did in 1980. Can you give me a feel for whether that figure is in the ballpark and if there's any way we could trim back civilian employees for the Defense Department?

Mr. MILLER. I think that figure is in the ballpark, and, yes, I think we can trim some. One of the problems is, I understand last year Congress forbade OMB from setting employee ceilings for Defense, I think just for Defense. I think a return to the procedure we have with all the other agencies might be able to restrain the growth of civilian employment in the Defense Department.

Mr. BROWN. I notice the Grace Commission report indicates that we have literally hundreds too many military bases. Is the administration in the process of developing a list of military bases that it might close?

Mr. MILLER. I think there have been such lists around for some time.

Mr. BROWN. Obviously we are familiar with one that was suggested recently, but the 2 or 3 that I know of is somewhat short of 400 or 500.

Mr. MILLER. Right.

Mr. BROWN. I'm wondering if you all are working on that?

Mr. MILLER. We are unable to provide such a list. Perhaps you could contact DOD.

Mr. BROWN. Two other things, I guess. Regarding postal subsidies for the political parties, what is the administration's feeling on continuing to subsidize the mailings of our political parties?

Mr. MILLER. The administration proposes to terminate postal subsidies for National and State political parties. The administration believes that taxpayers should not bear these costs.

Mr. BROWN. One last thing, the Davis-Bacon Act obviously dramatically increases military cost. What is your feeling about repealing or modifying the Davis-Bacon Act to save funds in the acquisition area?

Mr. MILLER. First, let me say, the administration has this matter under review right now and will be indicating some judgment about it. I think there's a general feeling that certainly there are ways in which Davis-Bacon leads to excessive costs. There are certain ways in which Davis-Bacon is applied that lead to excessive costs.

Mr. BROWN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Brown.

The Chair recognizes the gentlewoman from California, Mrs. Boxer.

Mrs. BOXER. I thank the Chair very much.

I would like to say to you, Mr. Miller, first of all, welcome to your new job, and you strike me as someone who is very open and frank, and I would like to be the same with you.

Therefore, I would like to tell you that I think your budget is in serious trouble. I think there are two reasons for it being in trouble. One of them is a reason that I think is fair and right, and that is a difference in priorities with the Congress, and certainly you have to reflect the President's priorities, and that's right, and so that's fine; that's a difference that we could quibble about, but I can't expect you to answer for that.

But the other is the issue that our chairman talked about at length in his opening remarks, which is these estimates. And without getting into the whole thing again, I guess I have to disagree with my colleague from Colorado, Mr. Brown, when he congratulates you on meeting those estimates.

I think this chart says it all. CBO isn't exactly a partisan organization, and they have been on the mark before. They have never come in like this. And I think you're in trouble, because I think that this $14 billion is a big difference, and it's more than just a technical problem. I think it's of substance, and I think what it leads some people to think is that perhaps, just perhaps, the administration is hiding the actual extent of the military buildup, and I think that the American people are aware of this, and that's why I think the budget is in trouble.

In a Gallup poll, 59 percent of the people recently polled stated that they felt that we had to cut the defense number, cut the defense numbers, from last year. The press has stated that your buildup is not a 3 percent buildup, but in actuality it is an 8 percent buildup, plus you add on inflation, it's 12 percent, while you're knocking the other programs that I think, frankly, that some of them are a real investment in the future of this country, whether it's strategic petroleum reserves or education for our kids.

So I think the budget is in trouble, and what I would hope that you would take away from here today is the words of the chairman and the majority leader when they urge you—and, of course, Mr. MacKay, who pointed out the problems with some of the assumptions—that of course you can't change the priorities; that's not your job. You reflect the priorities of the administration. But you can change some of these numbers.

Now when you put together the budget, I'm assuming you considered all areas where there was waste or fraud or abuse where savings could be made; am I correct in that?

Mr. MILLER. Yes.

Mrs. BOXER. I have a hard time imagining that you did that with the Pentagon budget. I've been involved somewhat in some of these issues.

I'm sure you've heard about spare parts abuses in procurement, cost overruns, contract modifications, unpriced orders, padded profits, allowable cost areas where contractors are ripping us off and we're paying them back for costs that shouldn't have been allowed in the first place.

Did you take a real hard, long look at that to see whether or not you could have cut back some of the funds and attributed that to some of these areas of waste and tell the Pentagon to shape up?

Mr. MILLER. Well, look, no matter what the number is that you put in the defense budget, Mr. Weinberger and his colleagues and Will Taft and others have strong incentives to eliminate waste, fraud, and abuse. It's not just a matter of what the top line is. Whether the defense budget authority is $300 billion, $400 billion, or $200 million, we have an incentive to eliminate waste, fraud, and abuse. We're all working on that.

Unfortunately, some of the horror stories that have come out have backfired, in a sense, on the administration. When you have hundreds of thousands of sales, and you go through and check invoices, and you find a few mistakes, and you say, "See, we caught somebody," sometimes these cases where you find mistakes get blown out of proportion and then begin to be viewed as business as usual.

So I think it's a reflection of the degree to which the administration has been aggressive and found so many cases of overpayment, et cetera, and then turned around and billed the companies and gotten the money back for the taxpayer.

Mrs. BOXER. OK. Well, let me just assure you that, having been involved in this for 3½ years now, that it is true that within the administration, there have been some discoveries, but I can assure you that the preponderance of these things have come from whistleblowers. They've come from Members of Congress and committees and so on.

I would take issue with the fact that there's an incentive for Mr. Weinberger here, because he's got a lot of unobligated balances. Some people talk about many billions of unobligated balances, slush funds for inflation, other kinds of things. So that I would wish and hope that as you go back and take a look at this this year and in future years, you will look at this whole area of waste, fraud, and abuse.

You talked a bit about Social Security, and I agree with you, it's a separate trust fund and, therefore, is left on its own. Isn't the highway trust fund a separate trust fund?

Mr. MILLER. It's a separate trust fund.

Mrs. BOXER. Then why does the President decide to cut that back?

Mr. MILLER. Well, what we have done in the highway trust fund this year is to propose outlays from the trust fund exactly equal to the revenues acquired by the trust fund, and the trust fund would essentially, then, accumulate the interest on the balance already in the trust fund.

Mrs. BOXER. Well, my understanding is, you've cut a little bit deeper than that and, in fact, if you use this trust fund as a rationale for not touching Social Security, I'd like to see those highways get what they need.

Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. The Chair now yields to the gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Chairman, thank you.

I'd like to start off by observing one thing. I'm disappointed that more of our colleagues on the minority side have not attended today's hearing or the Weinberger hearing a couple weeks ago or the field hearings, because, quite frankly, I think all these hearings have been good, and I would urge the minority members who have been here and who have participated, both in the field hearings and the hearings here in Washington to urge their colleagues to attend our hearings in Washington. The questions that have been asked from the minority side have been every bit as good today as the questions asked from the majority side, and I just wish more of them were here taking part.

I would like to ask you a few questions, Mr. Miller. There are varying figures, and our committee has prepared one chart on outlays, and of course there are figures on authority. But regardless of what all these figures show, what happens in terms of priorities if this committee decides to have a freeze in terms of either outlay or authority, a freeze which brings the military down and brings domestic up, nets out basically the same deficit figure? Just the reductions we make in military will be offset by domestic increases.

What would be your position, then, to the President? Would you recommend that the President support a revenue increase in order to get his defense number back up, or would you recommend to the President that he simply accept the freeze concept and get a lower defense figure and not go with revenues?

Mr. MILLER. I really wouldn't want to say what I would recommend. First I would have to look at the details, and then I would make my recommendation. But I just think that any recommendation that I make to the President of the United States ought to be between the two of us and shouldn't be speculated on.

Mr. FROST. Let me ask another question, then. In the event that a decision were made by the President after much consideration to support some additional revenues, for whatever reason, do you think that an appropriate type of additional revenue would be an oil import fee? Is that something you think would be wise or not wise?

Mr. MILLER. Congressman Frost, I kind of got myself into a bind yesterday trying to answer that question. First let me say it's kind of like you're giving me a barrel of rotten apples and saying which one do you want to eat? I will just say what I said yesterday and I won't go any further than that because it's complete speculation.

I am opposed to a tax increase. The President is opposed to a tax increase. But if you had to have a tax increase—and I'm not saying how it would come about and I'm not admitting that it ever would come about—I think what you would ask is what kind of tax increase would have the least adverse effect on our economic expansion, and that would probably not be an oil import tax.

Mr. FROST. What type of tax would be?

Mr. MILLER. Well, it would be a broader tax, and there are many broader taxes, whether income tax or corporate tax or something like that.

Mr. FROST. Could it be an excise tax on things like liquor and cigarettes?

Mr. MILLER. That would be fairly narrow. Again, you would look at the incidence of that and effects on economic expansion. I haven't done the analysis necessary to answer the question. I can tell you my guidelines, how I would look at the question, but if I had to eat one of those rotten apples, I would probably look for the one that had the least rot on it.

Mr. FROST. Let me be sure I'm clear on what you are saying. That would be an increase in the income tax and/or the corporate tax, that that would be the least——

Mr. MILLER. Those are broader based taxes than would be an oil import tax.

Mr. FROST. I would tell you, Mr. Miller, that there is no much support on either side of the aisle for an increase in the income tax. If we are talking about what is politically comfortable——

Mr. MILLER. Mr. Frost, don't put me in a box by demanding I answer a hypothetical and then telling me there is no support for it. I am opposed to it, as well.

Mr. FROST. No, no, but you have offered what would be the alternative if we had to have a revenue, and I am just reporting back to you that the one you have offered up would be the one that would be the most difficult to pass.

Mr. MILLER. Well, I didn't do that strategically.

Mr. FROST. Let me turn to another area. We had a field hearing in Dallas, one of the five. It was an excellent hearing. In fact, we had three Republicans attend that hearing as well as Democrats. It was a bipartisan hearing, and there were some very good questions, I thought, that came out of it. One of the things we looked at was air safety. There is a lot of concern in my part of the country about air safety. We had a crash, as you may know at DFW, back in August.

One of the concerns that was raised was——

Mr. MILLER. The crash of an airplane that was just exactly the type my Dad used to fly for Delta.

Mr. FROST. Since I fly between Washington and DFW quite frequently, it did catch my attention, and my question is: There has been some criticism raised—it was raised by Jim Oberstar, who is chairman of one of the subcommittees of Public Works that looks

into this—about the use of money from the highway trust fund this year in your budget, the President's budget, to fund current operations of the FAA rather than using that exclusively for safety. Could you tell us why that was done?

Mr. MILLER. First, you mean the airport airway trust fund rather than the highway trust fund. I thought maybe I heard wrong.

Mr. FROST. Yes, I'm sorry. I meant the airport trust fund, of course. That there was money taken out of that trust fund and used for FAA operations rather than exclusively for safety, which it was originally designed for.

Mr. MILLER. Well, a lot of the moneys were used for construction, new airports and so forth. I just don't know the details. The fact of the matter, of course, is that the budget for FAA is proposed to be increased.

Mr. FROST. I understand, but the concern is that you are doing that by taking money that was set aside for one purpose in the airport trust fund and using it for another purpose, FAA operations, which have not previously been funded out of the trust fund.

Mr. MILLER. But my recollection is the airport trust fund did not have as its single purpose aviation safety.

Mr. FROST. Well, there is a difference of opinion among the Members of Congress who sit on the subcommittees that administer that trust fund, and they do not see it the same way you do. It is a matter of a great deal of concern to those members, and, of course, I would think it is a matter of concern to the flying public.

The CHAIRMAN. The Chair recognizes the gentleman from Texas, Mr. Boulter.

Mr. BOULTER. I thank the chairman very much.

Mr. Miller, my friend the chairman of this committee in his opening statement referred to the field hearings that the Budget Committee went on, as has my colleague Mr. Frost, and I thought the chairman seemed to say or suggest or imply that after all of the hearings, the American people do want to reduce the deficit but they don't like the President's budget.

Of course, nobody likes it perfectly, and there are many, many of us, even on my side of the aisle, Mr. Miller, who think we are not getting enough bang for the buck on our defense spending and we do think you have got to take another look at that. But I attended one of the Budget hearings, the one in Dallas, and it is true that all of the witnesses there, with the exception of one, certainly did not like the budget. In fact, if I thought those people really were typical of my State and of Dallas, I would really worry about it.

Their only suggestions—they had no suggestions as to where to cut spending in nondefense, domestic areas that I caught—were about how to deal with the deficit through cutting defense and raising taxes of some sort or another.

I think that the American people support the President in his effort to get to a balanced budget by 1991 without a tax increase, and toward that end, the budget, as I see it, has some cuts for domestic spending, some privatization, and some program terminations.

We went through this last year—my first year on this committee—and the President proposed terminating, I think, 21 programs in the budget for fiscal year 1986. The Senate in its budget resolu-

tion had 17 program terminations. I remember well that in the House, the Republicans in their alternative had 13 program terminations. As I looked at that list, I was sorely disappointed to note that none of those terminations were included in the final CBR.

Now, you talked about your job as a salesman, and I do think you are a good salesman. In fact, I think that the American people could look at those 21 programs and think, well, my goodness, there is at least one program here somewhere that we could do without, that either the Government shouldn't be involved, is not getting the job done, or is too expensive.

What was the problem with getting any of these programs terminated last year, and how are we going to get it done this year, if we are?

Mr. MILLER. I think to some extent the salesmen, whether it is Dave Stockman or Jim Miller or the Cabinet members or others in the administration, need to make some more calls. The second big difference, I think, is there was a barrel of red ink last year, and it's a vial of $144 billion now this year. So we have to make some tough decisions.

Mr. BOULTER. All right. Now, let me just talk to you about one, say Legal Services Corporation as an example. I assume that you would agree with me that we do have a policy, a very good policy, of wanting poor people to have affordable legal services when they really and truly need a lawyer; that we want to provide them access not only to the criminal justice system but to civil jurisprudence, as well, and to legal services.

If we terminate that program, does that mean the end of that little part of the American dream, and likewise, if we terminate Amtrak, does that mean no more affordable railway transportation? If we terminate SBA, does that mean that small businesses aren't going to have access to low cost capital markets. What are we doing here?

Mr. MILLER. Let me take those in order. With respect to Legal Services, despite the fact that we have tried very hard to make Legal Services work—Jim Wenzel, the executive director, used to work for me at the Federal Trade Commission—it is very difficult to have a federally sponsored program that reaches down into those communities at that personal level and does well. The incentives for performance are very difficult to arrange to assure good performance.

My understanding is that if all the lawyers in America were to donate 20 hours a week, you would have exactly the same amount of legal service. Excuse me. A year. Excuse me. A year.

Mr. BOULTER. Thank you, as a member of the bar.

Mr. MILLER. Excuse me. It's getting long. I'm in the second 8-hour part of the day.

The second part is that, of course, some legal services would be available to low income people. In fact, one of the problems is that Legal Services has been somewhat substituting for entrepreneurs, for lawyers that provide those kinds of services on a for-fee basis.

On Amtrak, I once wrote a couple of papers on Amtrak. I believe that without the subsidy, you may find a viable system on the east coast and you might well find a viable system on the west coast. You would have corridor systems on the east and west coast and

you would have perhaps a spoke and wheel kind of system out of Chicago, but there would be no transcontinental railways of the kind that we have under Amtrak, simply because the subsidy is the only thing that keeps it going. The farebox does not pay for the system. The American taxpayers pay for the system.

For small business, of course there would be low cost loans if we did not have the Small Business loan program. In fact, 99 percent of small businesses do not get loans from the Government.

Mr. BOULTER. Thank you, Mr. Miller.

The CHAIRMAN. The Chair yields to the gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. Director, congratulations to you.

Mr. MILLER. Thank you.

Mr. LOWRY. Continuing on my friend from Texas' question, what about the elimination of SPRO?

Mr. MILLER. We propose, Congressman Lowry, to top off SPRO at 500 million barrels and to leave it there rather than to filling it to 750 million. For one reason, the evidence of the breakdown of the cartel makes it much less likely that we would have cut off of supplies. Second, because of lower imports today than we had at the time SPRO was created, even with 500 million barrels, I understand that we cover more days of imports than we would have covered then with 750 million barrels. But the particular savings, I can search for that.

Mr. LOWRY. That's all right. We can get that.

Do we have a homeless problem in this country?

Mr. MILLER. Pardon?

Mr. LOWRY. Do we have a homeless problem in this country?

Mr. MILLER. Yes, there are people that are homeless, and it's a very bad thing. It tugs on one's heartstrings. It is a very difficult thing philosophically or emotionally. You want people to have the freedom to walk out of a hospital, so you want to have laws against Government essentially incarcerating people. At the same time, you just can't help but think that they could be better off somewhere else, not on the streets. So that is part of the problem.

Mr. LOWRY. Within your budget, how are you approaching that? I have noticed the FEMA elimination.

Mr. MILLER. Yes, we have eliminated the FEMA part. We believe the homeless are not a Federal responsibility but a State and local responsibility, and there are a number of grants that we have to State and local communities for which they could use some of those funds for the homeless.

Mr. LOWRY. This would be out of which grants, the CDBG or CSBG;

Mr. MILLER. I think it's CDBG; CSBG.

Mr. LOWRY. CSBG is eliminated in your budget.

Mr. MILLER. Well, I don't remember. It's one or more of the grants that the homeless could be provided for.

Mr. LOWRY. But actually, out of general type grants.

Mr. MILLER. Right, not specific grants directly.

Mr. LOWRY. Not categorical-type grants.

Mr. MILLER. Yes.

Mr. LOWRY. As I read your budget stand on housing, the approximately 157,000 presently assisted housing units, 157,000, 1986 appropriated, will be replaced by 50,000 housing vouchers. I mean two-thirds of the existing housing units are going to go somewhere. How is that going to work?

Mr. MILLER. Let me say first, we have about $249 billion of unfunded balances for the Federal housing programs. The reason we switched to vouchers is that we recognized that vacancy rates are at an all-time high.

Second, we estimate that we can house a family by using a voucher and letting them choose where they want to live on about a third the cost we can by building them new Federal housing, and that is better for them because it gives them a degree of freedom that they don't otherwise have.

Mr. LOWRY. Of the present ones, a lot are utilizing existing housing. In other words, you gave an answer I have thought a lot about on the new, but the existing housing units are maybe 70,000 in HUD and 30,000 in rural. Replacing these with 50,000 vouchers, I mean isn't that going to be an awful lot of people out in the cold?

Mr. MILLER. No, because again, I think the vacancy rates—

Mr. LOWRY. This is still 100,000 units, and there are 50,000 vouchers. What are the other 50,000 going to use?

In the President's 1983 budget, Mr. Miller, he, I believe or I am told, had a couple of contingency taxes if the deficit got out of control.

To kind of continue on a question that you and others addressed about what Gramm-Rudman does to it this year. If we used, in this budget, essentially the administration assumptions and estimates and really did our job and wrote a $144 billion target using those assumptions, but then for things that were beyond—just plain happen in this assumption business, we missed by $15 billion or so or enough to trigger Gramm-Rudman, then about at that time, rather than going back to that same small party of the pot that gets the sequestering, the thing that concerns us all, what about at that time, after using the mystery assumptions and writing the $144 billion target and doing our job, we had instead a contingency tax?

Mr. MILLER. Well, let me say, you know, the way I understand that Gramm-Rudman would work is that we would make our estimates on August 20 and the sequestration order would be issued on September 1. Then there would be a whole month that Congress would have to act or the President could propose alternatives. A whole month—that's not long, I realize—but there would be a time that the President could propose and the Congress could come up with something else.

I mean, obviously if it came down and we're short, we'd have to do something.

Mr. LOWRY. Thank you, Mr. Miller.

The CHAIRMAN. The Chair recognizes the gentleman from New York, Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, and thank you, Mr. Miller also for staying the whole time and letting those of us who had to come in late get a chance to question you.

I have questions on three areas. The first is the baselines which we've talked about. I sat on this committee last year, and we thought the baselines chosen by the President were wrong. We had a discussion about whether we should resist accepting the President's baselines and substitute our own more accurate baselines. To be honest, the rug was pulled out from under us by the Senate side, which went along with the President's numbers. The result was that after we had done all our work and cut the budget by $50 billion, that deficit reduction vanished into thin air because the baselines were so wrong.

I think there is a much greater feeling on this committee this year that we must do our own baselines. If you will, the bloom is off the Rose Garden. We are not going to go ahead and do the same thing again that we did last year in terms of agreeing to unrealistic estimates.

Let's say Chairman Gray and Chairman Domenici come up with their own baselines. My question to you is, If the Senate and House should agree on a different baseline than OMB's, would you be willing to revise yours so that we would have agreement on a baseline?

Mr. MILLER. Well, I would certainly look at the reasons for your baselines, and if I thought that ours was in error, then I would revise it.

Mr. SCHUMER. From your answer, I understand that your baseline is not written in stone. That is good to hear.

Mr. MILLER. The relevant question, I think, is what happens in August when we do the estimate.

Mr. SCHUMER. The second question I have is this: We have beaten around the bush on the tax increase issues. Let's say the choice in Congress comes down to either not reducing the deficit significantly or increasing taxes. In other words, let's say we cannot reach the $144 billion target by spending cuts, but we can get to $164 billion. In this situation, would you recommend, say, a $20 billion tax increase, or would you recommend that we stay at the $164 billion deficit level?

Mr. MILLER. I would counsel with the President over that, and then the President would——

Mr. SCHUMER. What would you counsel him? I am just asking you to give us an off the——

Mr. MILLER. I wouldn't, again—as I answered Congressman Frost, I think that sort of advice to the President would be confidential.

Mr. SCHUMER. But you would not unequivocally say, "$164 billion and no tax increase" at this point.

Mr. MILLER. Well, with the $164 billion, and assuming that the Congress did pass the joint resolution and the President signed it that would trigger the sequester, the choice would really be between a tax increase and a sequester.

Mr. SCHUMER. No; assuming the Court of Appeals decision is upheld by the Supreme Court——

Mr. MILLER. Right; I am assuming that.

Mr. SCHUMER. Then you don't get—then Congress isn't going to vote on that extra sequestering.

Mr. MILLER. Oh, I don't know. That's the way that Congress would carry it out—it would implement Gramm-Rudman by doing a joint resolution.

Mr. SCHUMER. Right; but Speaker O'Neill and Majority Leader Dole may say, look, there is no way we can get a majority of our Members to vote that extra $20 billion sequestration. Would you go along with the tax increase, or should we stick to a $164 billion deficit and revise the Gramm-Rudman number? What would you recommend?

Mr. MILLER. I haven't thought that through.

Mr. SCHUMER. OK.

Mr. MILLER. And I will tell you, it's a tough choice. But I would counsel the President on that issue.

Mr. SCHUMER. My final question. Let's assume now that the Supreme Court restores the Gramm-Rudman sequestration process—or, in any case that the Gramm-Rudman automatic sequestration is about to be implemented. Assume the cut that is going to occur in the nondefense programs is approximately 20 percent. Do you think agencies like the FBI and IRS, just to pick two examples, can function after such a cut?

Mr. MILLER. Oh, they surely can function.

Mr. SCHUMER. With a 20-percent cut?

Mr. MILLER. Sure; they can function with a 20-percent cut.

Mr. SCHUMER. Could the IRS bring in as much revenues with the 20-percent cut as they do now?

Mr. MILLER. No, I don't think they would.

Mr. SCHUMER. So in reality, then, Gramm-Rudman would actually cost us some revenue money. Of course, this assumes that nothing changes and, in this regard, I note that you have already made a request for a supplemental IRS appropriation——

Mr. MILLER. The effect on the deficit would be less than the reduction in spending triggered by Gramm-Rudman, because there would be less revenues collected.

Mr. SCHUMER. So, in certain areas of the budget, it would be incumbent upon us to seek some kind of revision of the Gramm-Rudman cuts?

Mr. MILLER. No; the sequester is a club that we hope doesn't have to be used.

Mr. SCHUMER. In other words, we would not have to bludgeon.

Mr. MILLER. Yes, right.

Mr. SCHUMER. But what you are saying to me is, if we cannot come to agreement and the Gramm-Rudman club has to be used, then actual revenues would go down, at least in the case of the IRS.

Mr. MILLER. Well, the revenues would go down, but I don't think it would be anything like as much as the reduction in the total spending that would occur because of the sequester.

Mr. SCHUMER. I thank the Chair.

Mr. MILLER. But your analytical point is right.

Mr. SCHUMER. Thank you.

Mr. LOWRY [presiding]. Thank you. Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

Mr. Miller, I'm just curious about the administration's proposals to sell the naval petroleum reserves out at Elk Hills and Teapot

Dome. They are proposing that that be sold for a net revenue gain, I guess, to the Federal Government of about $2.9 billion.

Mr. MILLER. Yes.

Mr. SLATTERY. Mr. Miller, was that decision made prior to the oil price plunge?

Mr. MILLER. Oil prices were falling at that time. They have fallen further than we thought they would. That will affect the purchase price, but that does not affect the decision or the usefulness of the decision to sell them.

Mr. SLATTERY. So it doesn't make any difference to you whether you sell the oil for $15 a barrel or $28 a barrel?

Mr. MILLER. No, no; the reason is, the market will capitalize whatever direction the price of oil is going to go at any point in time.

Mr. SLATTERY. Well, to make a long story short, if you can sell that barrel, and if you're projecting prices at $30 a barrel, the reserves there are a worth a whole lot more than they are if your projected price is $15 a barrel.

Mr. MILLER. That's exactly right. If there is any reason for us to think that the price of oil is going back up, the market thinks it, too, and the market will pay more for that oil, because they think the price is going back up. So at any point in time, it doesn't matter whether the price of oil is high or low; it still makes sense to sell the——

Mr. SLATTERY. I don't understand that at all. I mean, if the projections are that prices of oil are going to go up, obviously the reserves that you're selling are worth one heck of a lot more than if your projections are that they stay at $15.

Mr. MILLER. No, no; maybe I misunderstood your point. Our proposal would not be to go out and say, anybody want to buy this at $15 a barrel, in which case you'd probably have a lot of people lining up. We'd go out and sell it to the highest bidder either way, in any event.

Mr. SLATTERY. But the fact of the matter is that the depressed prices today will dictate the market value of that today, and people right now are projecting that your price of oil is substantially less than they were 6 months ago even.

Mr. MILLER. Right.

Mr. SLATTERY. It just seems to me that it would be a very inappropriate time to be selling off a very important asset of the Federal Government, at a time when prices are depressed.

I have other questions. I want to just go on. But basically what you're telling me is that the decision to sell was made prior to the plunge in the price of oil, and that's what I wanted to get at.

Mr. MILLER. But the important thing is that a thing is worth what it's worth. If there's any expectation that the price is going to go up, the market will register that.

Mr. SLATTERY. Amen. You're talking ABC's. I agree with what you're saying. I mean, that's simply enough.

The other question I have relates to the whole question of pay for both Federal civil service workers and for military people in this country. And in the budget, you are proposing a 3-percent pay raise for Federal civil service employees, effective January 1, 1987, a 4-percent pay raise for military, effective October 1, 1986. You

assume a 3-percent cap on Federal civilian pay through 1991, so there would be no more than a 3-percent pay raise during that whole period is what you're projecting, while at the same time, from 1987 through 1990, you're projecting pay increases for the military from 4.5 to 5 percent.

Now in addition to this, you're proposing significant structural changes in the Federal civil service retirement plan, while not touching the military retirement plan, which David Stockman, your predecessor referred to as a mockery, and the Grace Commission has taken all kinds of potshots at.

And I'm just curious, how can you justify these kinds of recommendations in any sense of fairness, in light of the fact that military pay has been increased by more than 40 percent in the last 5 years?

Mr. MILLER. Well, I think very importantly we need to have pay raises sufficient to attract the kinds of people to both civilian and to military employment that we want.

Mr. SLATTERY. Basically, what you're doing, Mr. Miller—and I only have 5 minutes—but basically what you're doing, if you compare your pay raises with your assumptions with respect to the Consumer Price Index, you're, in effect, saying that Federal civil service employees in 1990 are going to be making less in real dollar terms than they are today by a significant amount. That's what you're saying.

And all I'm saying is, Mr. Miller, in light of the fact that you are a great disciple of the free enterprise system, as am I, I would point out to you that you are building in a disincentive to work for the Federal Government on the civilian side, a significant disincentive. And when you tamper around with the retirement plan, you have created an even greater disincentive. And when you match that up with what you're talking about with the military, then you get back into the realm of perhaps reality in light of what your inflation projections are.

The next question I have is——

Mr. MILLER. Well, could I answer your question or the point you raised?

Mr. SLATTERY. Very briefly. I'm short of time.

Mr. MILLER. OK. Let me just say, of course, that people in the civilian ranks of Government do get step increases and also grade increases. So even if there were zero raises, as we talked about, people would still get salary increases, by and large.

Mr. SLATTERY. Well, seeing that they did not peak out in terms of their grade and——

Mr. MILLER. That's right. That's right.

Mr. SLATTERY. But there will be a lot of people that you want to retain that have peaked out, that aren't going to be able to realize any sort of increases.

Mr. MILLER. No; and that is obviously something——

Mr. SLATTERY. The next question I want to focus on is the whole question of what the administration and the President is talking about with respect to the Guaranteed Student Loan Program. Basically what you're talking about is a cut of 30 percent in the GSL's and at least a 23-percent reduction in other student financial assistance, and I would point out to you that the proposed changes in

the GSL Program, in my judgment, from what I get back in my part of the world, threaten the collapse of the entire program. Institutions and banks are saying that, in effect, based on your proposals, they're not going to participate in the system, and they're worried about the entire system, the GSL Program, being in effect terminated. Is it the policy of this administration to terminate the GSL Program?

Mr. MILLER. No, we're not. We have not embarked upon a program to terminate the GSL Program. But we're doing a lot of tightening up. I mean, for example, we're going to ask students to have high school diplomas before they get a guaranteed student loan. We've had a lot of people apply for guaranteed student loans who don't have a high school diploma, who don't anticipate going to school and staying in school, and who default on the loans.

We're going to try to tighten it up, and we're going to direct those loans to the people who are lower income. You know, the proportion of students on guaranteed student loans has risen dramatically over the last 20 years. We did have colleges when we had no guaranteed student loans from the Federal Government. We did have many good, fine colleges and universities.

So I don't think it's sort of an all or nothing kind of question. But we have targeted the program not zeroed it out.

Mr. LOWRY. The time of the gentleman has expired. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Mr. Miller, I apologize for being late. I welcome you to the committee.

Mr. MILLER. Thank you.

Mr. JENKINS. Did you go to school at Emory?

Mr. MILLER. University of Georgia in Athens.

Mr. JENKINS. My old alma mater. How much was the tuition when you went to school down there?

Mr. MILLER. At the university, I don't remember. It was about $1,200—no, excuse me—it was about $300 or $400 a year.

Mr. JENKINS. Well, I really have great fears that you're going in the wrong direction in tightening up too severely on educational assistance. I know what you're intending to do, but I don't think it squares with the real world and today's educational cost.

I guess my tuition and your tuition was very low at the University of Georgia, and today it's rather low. But there are many students from low middle income families that simply cannot, under any work program or anything else, really make sufficient funds to go to college. And that's true at the University of Georgia or North Georgia College or wherever.

My district doesn't benefit a great deal from the Trio Program, for instance, that you want to cut rather severely, but I really believe that if you want to encourage black students to go to college, you have to have some incentives and, some support for the colleges. It appears to me that you're really taking a bite out of this program.

Are you anticipating any—I assume you're not—severe problems there?

Mr. MILLER. Well, no. Again, what we have, I think, is a balanced program of Federal support for higher education and guaranteed student loans. We're trying to tighten up some of the eligi-

bility requirements, trying to make them available to the lower income students and those who do display a need.

The market has developed over the years, more so than many of us thought would have been the case 20 years ago, for student loans. There is, as the economists say, an imperfection in the market for human capital because you can't use your brains as collateral for a loan. And for that reason, lending institutions have been reluctant to make loans. But institutions are developing to the point that there are alternatives to a guaranteed student loan and alternatives to scholarships, so we do not anticipate significant disruption.

Mr. JENKINS. Well, I hope you're right, but I think that you're going to realize that there are real problems that the administration is not now seeing, even from some of the more reasonable colleges, as far as tuition costs are concerned. It's causing a real problem.

Let me ask you about legal aid, because I've been a critic of this program through the years, and I've seen most of the fat trimmed out. But I'm concerned about the total elimination, because I really believe that the program is working.

You obviously do not think the program is working now. Specifically, what type of cases is legal aid now performing that should not be performed?

Mr. MILLER. Well, again, many things are useful. The question is whether they're worth what the taxpayer is paying for them, and what are the substitutes, what are the alternatives.

We believe the alternatives are a greater participation by lawyers in legal volunteer work. We believe the solution is also the development of an infrastructure of lawyers either working independently or working in law firms, to provide this service at reasonably low cost to low-income people.

Mr. JENKINS. I don't believe that's occurring today.

Mr. MILLER. Well, the reason it's not occurring as much as it could today is because we have Legal Aid. There are a lot of things, a lot of legal services that poor people get that are not financed by the Federal Government. We're talking about the difference at the margin.

Mr. JENKINS. Well, what happened a few years ago, was that the bar did provide representation in criminal cases, but the bar did not provide it in civil cases, where there was a definite need. The bar did not provide for that need.

Are you saying that the bar would now provide those services?

Mr. MILLER. I think they may well provide some of those cases as well, sure.

Mr. JENKINS. Well, most of these cases involve disability cases, Social Security, that type of thing, where they need representation.

Mr. MILLER. I know I get in trouble with some of my lawyer friends about this, but I think there are also opportunities in some of these areas for representation by nonlawyers at lower cost.

Mr. JENKINS. Well, that may be an avenue that could be explored. Of course, we have so many lawyers now, opening the gates might show up the bar. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Jenkins. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you, Mr. Chairman.

Mr. Miller, I had a chance at you the other day in the Appropriations Committee, so I——

Mr. MILLER. Yes, a doubledipper. [Laughter.]

Mr. FAZIO. I thought I'd try to take another approach today. I notice you're still wearing your Adam Smith tie. It's getting worn out over this set of hearings, however.

Mr. MILLER. I understand it's strong enough. [Laughter.]

Mr. FAZIO. I'm not going to hit you on privatization. I think I did my bit on that the other today. I'd like to just hit on one theme and maybe let you talk. Unlike some of my colleagues, I'm kind of tired, just as you are, I'm sure, so I'll let you bear a part of the burden.

Mr. Stockman used to talk a good deal about his efforts to cut into the middle class programs, and he took some pride in his intellectual honesty and his approach to the budget. And I think to a certain degree, he carried that out, although I'm sure he lost a lot of battles before he got to the point of submitting this budget to us.

But I'd like to just take two areas, perhaps, and have you comment. First, in transportation, we're cutting $4.5 billion out of highways and mass transit. At the same time, we're spending $45 million for the hypersonic airplane initial development. I think you might want to submit for the record what that will amount to over time.

But, you know, we all know how little public use there is of the Concorde Program, and we really wonder who are we trying to help here, people who want to fly to Tokyo in 2 hours, or people who want to get home from work in 1 hour.

I personally think you've got our priorities somewhat out of whack in that area, and I think it tends to be biased toward folks who have the means to travel on an intercontinental basis. First are the folks who don't have the means to travel across town to get a job.

And let me take a look at Medicaid and Medicare. We cut Medicaid by 3 percent in 1982, 4 percent in 1983, 4.5 percent in 1984. We're back in for cuts that will total through 1989 $7.4 billion, and, of course, we've already forced the States—and certainly in my case, the State of California has been in the forefront of this—to engage in every effort they possibly can to cut expenditures—prospective reimbursement, error rate controls. Some States who have a major investment in these programs will have a lot of people already eligible for receipt of these benefits. They have been way out ahead of the Federal Government, but they get no credit for any of the savings they have been able to garner.

I look at the Medicare cost reductions, and I see, in the context of rich and poor, absolutely nothing that would in any way insulate low income people. We have percentage cuts, increases in copayments and deductibles. Part B goes up from 25 to 30 percent of program cost. It is across the board kinds of cuts that tend to burden everyone equally and do nothing to mitigate the impact on the lower income recipients of Medicare versus the upper income.

We have, you know a debate going on in the Democratic Party between Governor Babbitt and people who think it's time to look at

means testing in Medicare. And I think Dave Stockman was coming from that perspective.

I'm wondering, where in this budget, in the philosophy that you bring to OMB, is there some new approaches to trying to insulate the poor? You know, you talk about safety nets and the way in which you protected these people in these programs. But in transportation and in health care, it seems to me you're going in the opposite direction.

The cuts are burdening low-income people, and middle and upper income people are being relatively well treated in terms of these priorities. That's my assertion. I'd be happy to hear your rebuttal.

Mr. MILLER. OK. Let me respond in the following way: The reason that we're making some cuts—especially in the mass transit area—is we find these are notoriously inefficient ways of getting people home in 1 hour. There are lots more cost effective ways of dealing with these problems. We leave it up to State and local governments. If they want to provide that, then they can provide that. But no longer should the general taxpayer, including those that live far from any mass transit system, be required to foot the bill.

The hypersonic plane, the President's characterization of it as a plane that could go from the west coast to Tokyo, was more, I think, a description of the technical features of the plane. Of course, as you could well imagine, the advantages of such a plane for perhaps a lot safer exploration of space is not to be underestimated.

On the Medicare area, what we are attempting to do in this program is to continue providing all the services to Medicare patients. In fact, those that would be hit—and those that I suspect, Mr. Fazio, you will find complaining the loudest—are hospitals and physicians, and they are hardly the lower income people.

Mr. FAZIO. Well, certainly, they will be. But so will be the recipients who will have to put more out-of-pocket expenditures out, even with the current reimbursement rates, because, you know, that is what really does happen. When you cut down on the cost of health care in one place, it pops up somewhere else. Mainstream patients, insurers, and others pick up the difference. There's no question about that.

Mr. MILLER. It's called the Le Chaterlier principle, I understand. It can be applied very broadly to economics as well as policy analysis. I'm not saying there's no Le Chaterlier principle there, but we do not believe that Medicare recipients would be harmed under this program.

Mr. FAZIO. Well, what about the Medicaid cuts?

Mr. MILLER. What we're doing is asking the States to find more cost effective delivery mechanisms, but at the same time giving them freedom from the regulatory restraints that the Federal Government has used in the past that prevent them from finding a more cost effective means.

Mr. FAZIO. Well, we're giving them a heck of an incentive, telling them they're going to get less money every year whether or not they've made improvement in the way they manage their program. And in some of these States, many of them more affluent, as a matter of fact, we still have a very low percentage of the eligible poor on the Medicaid rolls. So if we ask them to fulfill the responsi-

bilities that they have under the law, at the same time reducing the ability for them to find funds to administer the program, I think we're being a little inconsistent—in fact, a lot inconsistent. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Fazio.

Mr. Miller, you have been quite patient and quite candid in your responses. I have three questions which I would like to pose to you, but not for answers right now.

Mr. MILLER. All right.

The CHAIRMAN. You can get back to me on a later date.

Contrary to popular belief, on our field hearings, there was not just a chorus of boos on the President's budget. We asked people about alternative suggestions. One of them that came forward was the one that Mr. Atkins raised, which is a tax amnesty program in order to collect more revenues, and I know that the President has often stated his concern about people who are not paying their taxes. Could you all take a look at that issue? It seems to me that we could perhaps make some adjustments in that area, where you wouldn't be raising, "taxes."

Mr. MILLER. I know. I know.

The CHAIRMAN. But you could increase the revenue base.

Mr. MILLER. Well, you know, Mr. Chairman, the problem is that it raises the jeopardy that people won't pay. Some people will say, "Well, maybe I won't pay some taxes I owe, and maybe I'll pay them later" or something.

The CHAIRMAN. No, no; we don't want to do it that way. Could you look at maybe the model of Massachusetts, because that's one that came across?

Mr. MILLER. Yes, I know.

The CHAIRMAN. My second question is, I note that the President has and you have in the budget the privatization plan. As one who is strongly criticized for taking cash out of the register of OCS and now finding out this year that the register, the counter, and the whole building is being sold, I'm not exactly what you'd call all warmed up about the idea of privatization.

But I would like to know, do you have anybody who is lined up, who is interested in buying Bonneville, et cetera, et cetera, those things you're going to privatize?

Third, how did you determine the price on these privatizations? If you could just get back to us on that in writing.

Mr. MILLER. Right, OK.

The CHAIRMAN. There will be additional questions we will submit to you in writing, but we really appreciate your first appearance before the committee. Sorry that it took so long, but, you know, you went through a lot of it the week before last, and at least you got a week's rest.

Mr. MILLER. I had the flu last week.

The CHAIRMAN. The Senate will do that to you.

Mr. MILLER. Right. [Laughter.]

The CHAIRMAN. Thank you very much. This hearing stands adjourned.

[The following information was supplied for the record:]

Tax Amnesty Program

The IRS and Treasury are now evaluating the results of the tax amnesty programs conducted by a number of States. We will be interested in Treasury's assessment of these experiences, particularly the effect the programs have on honest taxpayers and long-term compliance.

The amnesty proposals do spark interest because they would not raise taxes, but simply collect those taxes already owed the Federal Government. The IRS may also be able to keep better track of cheaters once they return to the Federal tax roles.

It should be remembered, however, that the IRS is much more sophisticated than States in identifying and collecting unpaid taxes. The use of the many IRS enforcement resources may still be the best long-term approach for collecting unpaid and overdue Federal taxes. In general, IRS enforcement activities and penalities are already much higher than State tax collection efforts.

The 1987 budget for the Internal Revenue Service contains several proposals that should encourage citizens to fully comply with Federal tax laws. These proposals include:

—the addition of 2,500 auditors to increase the percentage of returns audited;

—increasing appeals and tax litigation staff by 500 personnel to settle outstanding tax shelter cases;

—the addition of 800 positions to enable the IRS to match 97 percent of all information returns, such as W-2's and 1099's, against tax returns;

—a cost of collection fee which will increase the penalty for failure to pay taxes from ½ percent to 1 percent per month of the taxes owed.

Privatization: Power Marketing Administration (PMA's)

The budget assumes a price equal to the unpaid Federal investment at the time of the sale. The specific assumptions for the individual PMAs are as follows (in millions of dollars):

	1988	1989	1990	1991	Total
Proceeds from sale of assets:					
Bonneville	1,000	1,000	3,425	3,425	8,850
Alaska			174		174
Southeastern				1,383	1,383
Southwestern	800				800
Western area		500	2,172		2,672
Subtotal	1,800	1,500	5,771	4,808	13,879

In the case of Bonneville Power Administration, discussion began in the Pacific Northwest last year regarding the possibility of a regional buy-out of Bonneville. In the case of Alaska Power Administration, discussions were held with the State of Alaska and joint Federal/State study efforts are now underway. In the case of the other three PMAs, the Department of Energy has begun informal discussions with current PMA customers and other interested parties.

Privatization: Naval Petroleum Reserves (NPR's)

The budget assumes that the reserves are sold for a price of $6.00 per barrel of recoverable reserves. This estimate reflects the recent average of sales of commercial oil fields in the United States. At this price, the proceeds from the sale of NPRs would total $3.6 billion. This estimate is conservative in that it does not include the value of by-products (natural gas and other hydrocarbon liquids), nor does it account for the fact that the NPR oil is higher quality and the costs of operation are relatively low. In a separate analysis, the Department of Energy estimated that proceeds from the sale of the NPRs could be $3 to $5 billion.

In addition, to the proceeds for the sale, the privatization of the NPRs would save appropriations of about $200 million annually for operation costs and could result in additional corporate taxes of over $100 million per year, plus continued payment of windfall profit taxes of approximately $100 million per year.

The Department of Energy has received a number of inquiries regarding the sale. We would expect that potential buyers would be identified through some form of public notice. The potential buyers could include oil companies, or other investor groups

such as pension funds, or mutual funds. Although the notion of selling an oil field may appear novel, commercial oil field sales constitute a $8 to $10 billion annual market in the United States.

[Whereupon, at 4:20 p.m., the committee adjourned until Wednesday, February 19, 1986.]

IMPACT OF THE PRESIDENT'S 1987 BUDGET

WEDNESDAY, FEBRUARY 19, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The CHAIRMAN. The committee will now come to order.

Today the Budget Committee will hear from Hon. James A. Baker, Secretary of the Treasury.

Secretary Baker, we welcome you and thank you for coming. This is your second appearance before us as Secretary of the Treasury and the administration's chief economic spokesman.

Last year we discussed large Federal deficits, rapidly rising debt, skyrocketing interest payments, deteriorating trade position, and the fairness of the budget priorities. Unfortunately, this year's topics remain the same. They remain the same because it has been so difficult to find a way to reduce the deficit that can win the support of the President and that is also fair and realistic.

Last year the President insisted on another large increase in military spending and no more revenues. He shot down several Senate plans that would have cut back little on cost of living allowances and raised revenues. Here we are again today with the same problem. The President's priorities have not changed.

Now the task, however, is more urgent than before. Federal debt and interest payments have increased again. The new Gramm-Rudman law says we must bring the deficit down rapidly; otherwise, we face the consequences of the sequestration process, either automatic or legislative.

Last week we took the President's budget to the country. I think it is fair to say that many were dismayed by the President's priorities. It is hard for families, for city and rural residents, for the poor and the unemployed to swallow the notion that domestic spending must be cut drastically while the military buildup is sustained.

They are willing to see the budget problem addressed by a combination of military and domestic spending restraints. In fact, one message came across very clear in our field hearings, and that is that the American public wanted strong deficit reduction.

They are also willing to include more revenues if it reduces the deficit, but they want action now. They don't want to sacrifice more jobs and farms and homes to misguided fiscal policy.

When will this administration help strike this compromise among the American people rather than standing where they are now?

We also want to hear your views on more particular economic and Treasury Department matters. What can be done about our failure to bring down the unemployment rate to a humane and tolerable level? How much correction in the damaging trade situation can we expect to see as a result of your work on international coordination? What kind of monetary policy does this administration want to guard against inflation yet protect the economy from recession following the sharp fiscal cutbacks required by Gramm-Rudman?

Why is the administration's 4 percent growth rate assumption more realistic this year than last, when it was overoptimistic by 60 percent?

Mr. Secretary, we look forward to hearing your views. We welcome you back to the committee. To reserve time for questions, we are going to ask you to summarize your testimony. It will be submitted it in its entirety for the record.

Prior to beginning the hearing, I would like to call upon Congresswoman Martin, who has been acting as the ranking minority member, to say a few words of welcome to you as well.

Mrs. MARTIN. A few words of welcome to the Secretary of the Treasury. Under the chairman's list, I was also going to add are you responsible for the fog this morning? But instead I would say congratulations on the many fine steps that have been taken by Treasury to ensure some of the greatest growth seen in America in the last century, and to make sure more people, more minorities, more women have jobs and opportunities because of the progressive monetary policy now being followed.

Our congratulations to you also on your attempts to bring the Third World nations into part of this economic loop so there can be success in that area.

If the Congress had been as successful fiscally as the administration has been monetarily, we probably would also not have some of the problems we have with the deficit. Of course, there are still difficulties, and we look forward, Mr. Secretary, to working with you to solve them and look forward to working with the administration not just to continue the growth but to make sure that growth increases and enlarges because in doing so we help each citizen in America. We welcome you.

The CHAIRMAN. Thank you, Congresswoman Martin. Mr. Secretary, welcome again to the Budget Committee. We look forward to your testimony.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Mr. BAKER. Thank you very much, Mr. Chairman.

I am pleased to be here today to address the state of the economy generally and the new budgetary path. We are seeking to build on the foundation of a solid economic performance that has already taken place.

The current economic expansion has now moved into its fourth year, and I think it shows few signs of slackening. Growth was relatively slow at some times during 1985, but by year end, the economy was gaining momentum.

Some favorable features of last year's economic performance, I think, deserve at least passing mention. Consumer price inflation at 3.8 percent remained in the 3.8 to 4 percent range for the fourth year in a row, and it is down sharply from the double-digit rate of 1980.

Employment has risen strongly in the current expansion by over 9.5 million people. The unemployment rate has been reduced to below 7 percent, and further progress is expected.

Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers despite the persistence of large budget deficits. Short term interest rates are down on average by about one-half percentage point in the past year, while many of the long-term rates are down by about 2 percentage points.

The prime rate is down to 9.5 percent, the lowest rate in 7 years. Ideally, we would like to have seen interest rates come down even further than they have.

All this added up to 1 year of solid economic performance in 1985. The stage has been set for sustained expansion and output in jobs and in income, and this is one of the most important prerequisites for improving the budget picture as well as the financial security of the American people.

During the current expansion, strong economic growth has been achieved in a much less inflationary environment than in the late 1970's. We must strive to extend that good record into the future.

The administration forecast calls for 4 percent real growth during the four quarters of 1986. This would seem to be a reasonable expectation. The consensus private forecast has been a little bit lower, around 3 percent, but the recent economic numbers are causing some upward adjustment in the private forecasts.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure. The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it does seem to me that the Federal Reserve has been doing a good job recently.

I would like to turn briefly now to the influence of the international economy on our economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries, we have seen some improvement in the world economy.

We hope to build on the progress this year and see stronger growth abroad. That trend would have a favorable impact on trade and economic growth in the United States.

Exchange markets have recognized these developments. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's

peaks has been reversed. This is good news for U.S. industry and good news for U.S. agriculture.

The U.S. trade deficit is likely to level off later this year. These developments should contribute to the U.S. growth and to a more sustainable medium-term pattern of trade and current account balances.

The G-5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been the downward movement in world petroleum prices. Although not without its cost, on balance this should increase growth and lower inflation in most of the world.

There are two major items on this year's fiscal agenda: Deficit reduction and tax reform. The large budget deficits that we face are due to excessive Federal spending. Certainly it is not because the American people are undertaxed. As shown in the chart attached to my statement, receipts are running a bit above the long-run historical average as a share of gross national product.

Despite frequent claims to the contrary, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties. Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken.

It would seem that Congress shares this view and is serious about cutting growth and spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly.

Between fiscal year 1985 and fiscal year 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior 6-year period, 1979–85, the rate of growth was about 11 percent per year.

Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP, from 24 percent in 1985 to about 19 percent in 1981. Receipts will be growing strongly in absolute terms as the economy itself grows, but receipts would remain close to a 19-percent ratio to GNP, slightly above the historical experience.

Receipts are projected to rise by about an average of 7.5 percent annually between fiscal years 1985 and 1991, close to the 8-percent rise averaged in the previous 6-year period. With receipts growing normally and outlay growth restrained to a lower path, the budget will move into balance by 1991.

The reduction in the growth of expenditure required to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way via sequestration across the board, or it can be done more rationally and selectively with respect for appropriate priorities.

The President's budget is carefully drawn to meet the Gramm-Rudman targets while preserving essential programs of the highest national priority. The only alternative to the domestic spending cuts emphasized in the President's budget are to raise taxes, to lower defense spending, or to cut Social Security benefits, none of which are acceptable.

There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue very clearly. He is firmly opposed to damaging the economy by increasing taxes.

Defense, which is the most essential duty of the Federal Government, must be maintained. So must a social safety net, including Social Security and entitlement programs for the needy.

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start but not a final product. The Senate Finance Committee has begun consideration of tax reform, and the administration has pledged its full cooperation in improving the House legislation.

Our major desired changes include the full $2,000 personal exemptions for both itemizers and nonitemizers, at least for lower and middle income taxpayers, provision of capital cost recovery allowances adequate to promote economic growth, and the protection of those allowances against inflation, a top tax rate no higher than 35 percent.

Tax reform remains a top priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year, but let me be very clear that the President will not compromise on matters of principle and he will not permit tax reform to degenerate into a tax increase in disguise.

Thank you very much, Mr. Chairman.

[Testimony resumes on p. 210.]

[The prepared statement of Mr. Baker follows:]

Testimony of The Honorable James A. Baker, III
Secretary of the Treasury
Before the
House Budget Committee
February 19, 1986

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the state of the economy and the new budgetary path. The major economic objectives of the Administration have been described by President Reagan in his State of the Union Message. Further details on this year's economic and budgetary outlook have been provided in the President's Budget and Economic Report. My remarks are an overview of the current situation.

We seek to build on the foundation of the solid economic performance that has already taken place. The current economic expansion has now moved into its fourth year and shows few signs of slackening. Growth was relatively slow at some times during 1985, but by year-end the economy was gaining momentum.

Some favorable features of last year's economic performance deserve at least passing mention.

- Consumer price inflation at 3.8 percent remained in the 3.8 to 4 percent range for the fourth year in a row. A table attached to my prepared statement shows the steady progress that has been made since 1980 when all of the measures of price performance were rising in the double-digit range.

- Employment has risen strongly in the current expansion, by over 9-1/2 million people. The unemployment rate has been reduced to below 7 percent and further progress is expected. The U.S. economy continues to display great job-creating ability.

- Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers, despite the persistence of large Federal budget deficits. Short-term interest rates are down on average by about 1/2 percentage point in the past year while many of the long-term rates are down by about two percentage points. The prime rate is down to 9-1/2 percent, the lowest rate in 7 years. Ideally, we would like to have seen interest rates come down even further than they have.

All of this added up to a year of solid economic performance in 1985. The latest economic information is generally favorable. Employment rose sharply in January and the unemployment rate fell. Other statistics have not been quite as strong but the year is off to a good start. The stage has been set for sustained expansion in output, jobs and income.

Sustained economic expansion is one of the most important prerequisites for improving the budget picture, as well as the financial security of the American people. During the current expansion, strong economic growth has been achieved in a much less inflationary environment than in the late 1970's. We must strive to extend that good record into the future.

The Administration forecast calls for 4 percent real growth during the four quarters of 1986. This would seem to be a reasonable expectation. The consensus private forecast has been a little lower, around 3 percent. But the recent economic numbers are causing some upward adjustment in the private forecasts. Those of us who advise the President on these matters feel that the current Administration projections are inherently reasonable although we also recognize that economic forecasting is at best an uncertain art.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure.

The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it seems to me that the Federal Reserve has been doing a good job recently.

* * *

I would like to turn briefly now to the influence of the international economy on our own economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries we have seen some improvement in the world economy. We expect to build on the progress this year. On balance, we expect stronger European and LDC domestic demand growth this year as they continue the process of shifting from export-led to domestic-led growth. Unfortunately there may be some weakening in Japanese growth as the previous stimulus from the trade sector is sharply reduced.

Exchange markets have recognized these generally favorable developments. The decline of the dollar since its peak last winter has been substantial. The yen is at a seven-year high against the dollar. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's peaks has been reversed. This is good news for U.S. industry and agriculture. The U.S. trade deficit is likely to level off later this year. These developments should contribute to a more sustainable medium-term pattern of trade and current account balances. The G-5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been the downward movement in world petroleum prices. Although not without its costs, on balance this should strengthen growth and lower inflation in most of the world. A few countries and firms will experience problems, but with the U.S. debt initiative and a strongly growing world economy these problems can be handled.

While the international debt situation has continued to improve, economic growth in many debtor countries has remained unsatisfactory, and requires greater emphasis on structural policy reforms within those nations, buttressed by additional international financial support. As you know, the United States proposed last October at Seoul, Korea a "Program for Sustained Growth", involving mutually reinforcing actions by the debtor countries, the international financial institutions, and the commercial banks. The response has been very encouraging, with broad statements of support from the major bank groups in the U.S. and other key creditor nations, from the multilateral institutions and in principle from many of the debtor nations.

* * *

There are two major items on this year's fiscal agenda: deficit reduction and tax reform.

The President's budget for fiscal 1987 provides a detailed plan, satisfying the requirements of the Gramm-Rudman-Hollings legislation, by which a balanced budget can be achieved by fiscal 1991. The large budget deficits that we currently face are due to excessive Federal spending. Certainly it is not because the American people are undertaxed. As shown in the chart attached to my prepared testimony, receipts are running a bit above the long run historical average as a share of GNP. Despite frequent claims to the contrary, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties.

Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken. It would seem that Congress shares this view and is serious about cutting growth in spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between FY 1985 and FY 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior six-year period, 1979-1985, the rate of growth was about 11 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from 24 percent in 1985 to about 19 percent in 1991.

Receipts will be growing strongly in absolute terms as the economy itself grows, but receipts would remain close to a 19 percent ratio to GNP -- slightly above historical experience. Receipts are projected to rise by about an average 7-1/2 percent annually between FY 1985 and FY 1991, close to the 8 percent rise averaged in the previous 6 year period. With receipts growing normally and outlay growth restrained to a lower path, the budget will move into balance by 1991.

The reduction in the growth of expenditure required to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way, via sequestration across the board. Or it can be can be done more rationally and selectively, with respect for appropriate priorities. The President's budget is carefully drawn to meet the Gramm-Rudman-Hollings targets while preserving essential programs of the highest national priority.

The only alternatives to the domestic spending cuts emphasized in the President's budget are to raise taxes, to lower defense spending, or to cut social security benefits, none of which are acceptable. There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue very clearly. He is firmly opposed to damaging the economy by increasing taxes. Defense, which is the most essential duty of the Federal Government, must be maintained. So must the social safety net, including social security and entitlement programs for the needy.

The outlay reductions would be expected to bring down interest rates with a beneficial impact on the entire economy. In addition, lower interest rates and a declining budget deficit will moderate the rapid rise in interest expense that has developed. This will free up funds for growth in essential programs.

The time has come to reduce what has clearly become an excessive rate of growth in Federal spending and to move toward a balanced Federal budget.

* * *

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start but not a final product. Our primary concerns are the following:

- the bill lowers marginal tax rates but the top individual rate of 38 percent and the corporate rate of 36 percent are still too high;
- the bill raises the personal exemption to $2000, but to only $1500 for taxpayers who itemize deductions;
- the bill fails to maintain the cost of capital at sufficiently low levels to promote economic growth.

The Senate Finance Committee has begun consideration of tax reform and the Administration has pledged its full cooperation in improving the House legislation. Our major desired changes include:

- full $2000 personal exemptions for both itemizers and nonitemizers, at least for lower and middle-income taxpayers;
- provision of adequate capital cost recovery allowances and the protection of those allowances against inflation;
- a top tax rate no higher than 35 percent.

Tax reform remains a top priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year. But let me be very clear that the President will not compromise on matters of principle and he will not permit tax reform to degenerate into a tax increase in disguise.

Conclusions

The U.S. economy turned in a solid showing last year and the outlook this year is for stronger real growth without much increase in inflation. Internationally, as well, there was progress during 1985 and we will be working to build on that foundation. Our major domestic agenda items are reduction of an excessive rate of growth in Federal spending as we move toward a balanced budget, and meaningful tax reform for the American people. We think that both of these efforts deserve and will receive strong bipartisan support.

RECENT PROGRESS AGAINST INFLATION

(percent change, annual rate, during period indicated)

	1980	1981	1982	1983	1984	1985
GNP: Implicit price deflator	9.9	8.7	5.2	3.5	4.1	3.1
Fixed-weighted basis	9.8	8.5	5.0	3.8	4.2	3.5
Consumer price index	12.4	8.9	3.9	3.8	4.0	3.8
Producer price index (wholesale prices)	11.8	7.1	3.7	0.6	1.7	1.8

Note: Fourth quarter to fourth quarter for GNP deflator, December to December for CPI and PPI.

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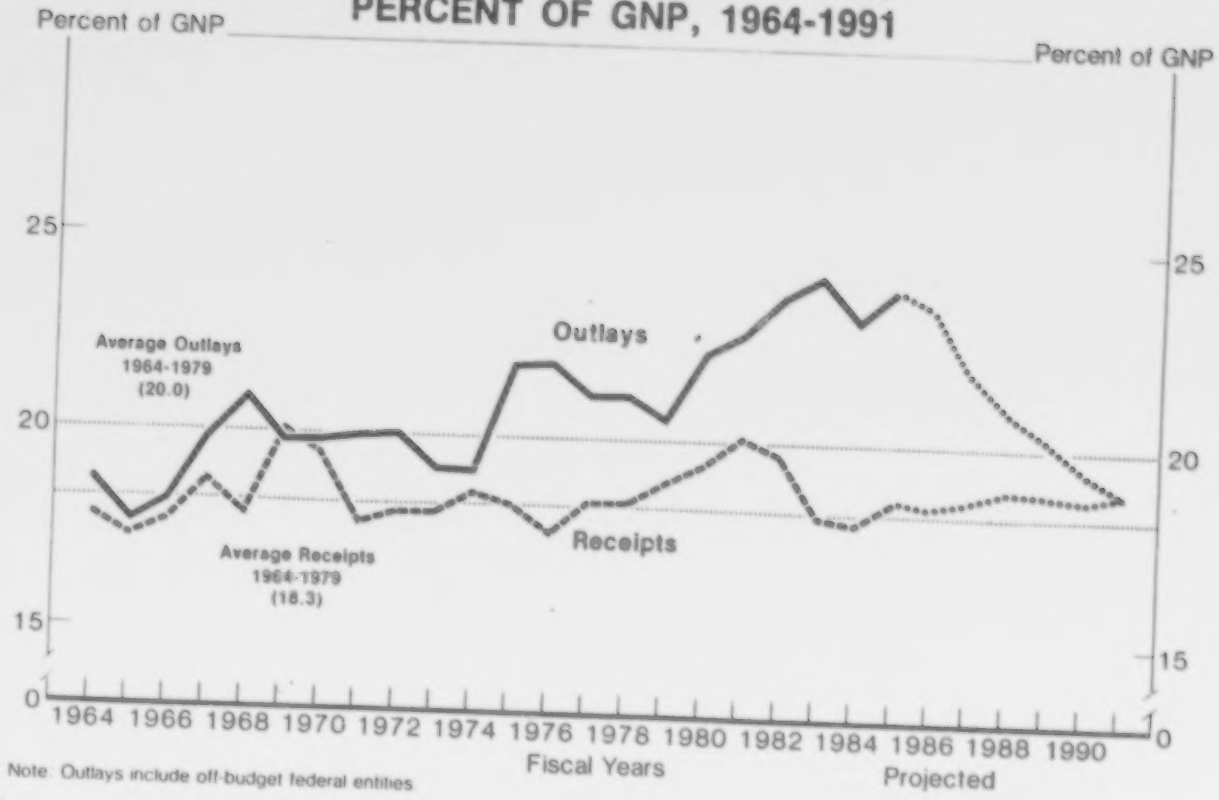
OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1991



Note: Outlays include off-budget federal entities

The CHAIRMAN. Thank you very much, Mr. Secretary. As usual, very concise and very much to the point.

First, let me also give a word of commendation to you in your efforts with regard to the coordination with other nations and the American dollar. If you had said to me several months ago whether that was going to be successful, I would have had grave doubts, but apparently you have been successful in getting some movement in that direction. I want to take this opportunity just to commend you for those efforts.

Last year the administration was 60 percent too high on the forecast for economic growth. That forecast was 4 percent. We have 2.5 percent, a substantially higher deficit. This year, you are again forecasting 4 percent and most other forecasters, including CBO, are lower than this. This year, we will pay a severe penalty because of Gramm-Rudman if we make any mistakes.

In the past, Mr. Secretary, we could give it our best guess and if we were wrong, nothing would happen. This year, if we do that, something will happen.

Would this have been a good year to be conservative on the forecast, to guard against an August surprise? Why is 4 percent this year any more likely than last?

Mr. BAKER. Mr. Chairman, as you know better than most, forecasting is not an exact science. We have missed on the high side in 1982 and 1985, but then we have missed on the low side in 1983 and 1984. I think it sometimes tends to balance out. I believe that the 4 percent figure is becoming ever more reasonable as we look at what the probable effect of the decline in oil prices is going to be with respect to growth.

It's not exact. However, our calendar year 1986 forecast happens to be very, very close to what the Congressional Budget Office has predicted. I guess the last thing I would say in answer to your question is that most of the private forecasters are now tending to revise their forecasts upward. They are coming closer to where the administration is. All and all, I think it is a very reasonable estimate.

The CHAIRMAN. Your testimony refers to the "great job creating ability of the American economy," and the rise in employment by 9.5 million jobs during the current expansion.

Let me ask a couple of questions here. Isn't some of this just regaining jobs lost during the recession, and isn't the actual net increase of 9 million substantially lower than the previous 5-year expansion of 12.6 million?

Mr. BAKER. I'm not sure I can answer the latter, Mr. Chairman. I don't think all of the roughly 9.5 million rise in employment since the end of the recession in November 1982, is simply regaining lost ground. Most of it represents new jobs. We have an unemployment rate today that is lower than it has been in over 5 years. We have a higher proportion of the American population working today than ever before in history.

I don't think the first part of your question is true. I'm not equipped to answer the second with respect to going back 5 years before 1980.

The CHAIRMAN. Has there ever been an expansion in which the unemployment rate was as high as 6.7 percent after 39 months of expansion?

Mr. BAKER. I would suspect not. We have a growing labor force. Again, we have a higher portion of Americans working today than ever before in history and that is probably the best measure of the economy's ability to create jobs.

The CHAIRMAN. I think that sort of confirms my point. I'm sure you want to point with pride to the 9 million jobs. I am concerned that we are not creating jobs fast enough. In particular, when you look back over the 5-year period before that, and we were up over 12 million for the same kind of a 5-year period.

My concern is that even though we see the overall figure down low, there are pockets, regionally and ethnically, that still remain disproportionately high.

I was wondering why do we not see anything specifically in the budget that is going to address dealing with those regional and ethnic imbalances? Do you have an answer there that we don't particularly see in graphic terms?

Mr. BAKER. I think there probably are regional pockets, Mr. Chairman. I don't deny that. You say you don't see anything in the budget that deals with that. We are not calling for the elimination or the eradication of some $418 billion in programmatic spending. What we are really asking is that you take a hard look at eliminating $23 billion of that $418 billion or $23 billion of domestic program spending against total spending of $1,026,000,000.

If you just look at it in terms of domestic program spending, it is a 5-percent reduction. You do it one time and it gets the budget into balance by 1991. It seems to me to be a reasonable approach. People say that this is all cutting on the domestic side of the equation. There were substantial defense cuts last year, as you are aware, from the President's top line. I think it is a total of $290 billion over 5 years that was agreed to in the fiscal 1986 budget resolution.

This budget calls for an additional $2.7 billion out of defense. It calls for $6.3 billion in revenues. It calls for about $3 billion in asset sales, and about $3.6 billion in other offsetting collections and interest saving.

What we are really talking about here is not $38 billion or some higher figure in terms of domestic spending cuts. We are talking about $23 billion to set this budget on a path to balance by 1991.

The CHAIRMAN. My concern is that as you acknowledge, there are some severe pockets of unemployment. West Virginia, 13.6 percent; Louisiana, 11 percent; if you look at ethnic unemployment, black adults, well over 14 percent. The recovery is certainly not everywhere. At the same time I see choices in the budget where we are drastically reducing the youth employment opportunities programs, that will cut out about 2.5 million slots, and also in the WIN Program.

That is why I asked the question. Even though there may be some good news and we want to rejoice in that good news, there is also a different state of America. I see a budget that will exacerbate those problems for minority youth unemployment, where you

are cutting back 2.5 million slots, the WIN Program, and nothing to address the regional.

One last question, Mr. Secretary. The administration consistently, as you have mentioned here, argues against taxes. The President has said, no taxes. He has even said it would be VOA'd, vetoed on arrival. Could you explain to me the principles behind the decision to include $29 billion of new revenues in this budget proposal, which may be called revenue enhancers by some, or user fees, but a rose is a rose; it's a tax.

Could you give me the distinction between these billions of dollars and new taxes that are being levied in this budget as opposed to what the President means when he says he is against taxes? Is there some criteria that he uses that allows some taxes but disallows others?

Mr. BAKER. I would be glad to try, Mr. Chairman. Before I do that, let me add something that has occurred to me with respect to your last question.

You asked why the job creation has been less than it was in some of the prior recoveries. What we are really trying to do is to promote sustained, steady growth without inflation. That may be one answer to why the job creation, if indeed it has been less, has been less than it was in the prior recovery.

In terms of your question with respect to taxes, basically these are, as you pointed out, user fees. The President has always said he sees those in a different light than he does a general broad based tax levied on the American people. He sees those as payment by the people who are benefiting of the Federal services for those specific services. He sees it in a different light than a general charge against the economy.

Furthermore, a substantial part of that $29 billion or $6.3 billion in fiscal year 1987, derives from a continuation, a simple continuation of the cigarette tax, at 16 cents per pack, as opposed to having it phased down to 8 cents.

The CHAIRMAN. I would just point out that I used the user fees as a quote because that is what the administration calls them. I don't. I think a rose is a rose, a tax is a tax. Whether you call it a user fee, it's a tax. In fact, in the budget it calls for equitable taxation of rail industry benefits. The word "tax" is actually used in the description of one of the items where you are going to raise additional revenue.

Mr. BAKER. That may be true with respect to one, Mr. Chairman. I think if you look at the detail, most of the $29 billion comes from an extension—just a continuation of the present cigarette tax and the imposition of new user fees that are really user fees, not the item you mentioned, but such things as payment to go into a national park, increasing the amount by which a park visitor pays to visit the park, customs user fees, IRS user fees. It is not unreasonable, I don't think, to suggest that the person requesting a specific revenue ruling be willing to pay for it. That is not a general tax or charge against the economy.

The CHAIRMAN. Mr. Secretary, it is still not very clear in my mind. When you are charging those taxes for FHA and Fannie Mae, which clearly is going to have a negative impact upon average working Americans, to own a home and buy a home, that is a

tax. A user fee implies that you are taking revenue and using it to finance a service. Clearly, when you look at the level of these taxes and these revenues, they are not being utilized to finance the regulatory agency or to pay for the service that is being rendered. It is just creating additional revenue which therefore means you don't have to make as many additional cuts.

That's why I'm concerned about——

Mr. BAKER. From 1981 on, Mr. Chairman, the President has seen a difference between a user fee and a general broad based tax levied against the American people or against the economy as a whole.

The CHAIRMAN. Thank you, Mr. Secretary. The gentleman from New York, Mr. Kemp.

Mr. KEMP. Thank you, Mr. Chairman.

I, too, would like to welcome Treasury Secretary Baker to the Budget Committee. Obviously, as the gentleman from Pennsylvania pointed out, there are pockets of the country and peopie who have been left outside of the recovery, but nonetheless, in my view, Secretary Baker is exactly correct in suggesting that in a macroeconomic sense, the recovery is not only astounding in terms of its length and durability and its possibilities for 1986 and beyond, but has been done without inflation.

It seems to me, Mr. Secretary, that one further elaboration on your answer to the previous question about the creation of jobs, never in our history have we created so many jobs without having to see a rise in the general price level, with producer price index soft and the wholesale price index actually dropping in 1 month, with all due respect to the criticism from the chairman, it seems to me that one very strong element in this recovery is it has been achieved without the rise in the price level and inflation.

Mr. BAKER. That is what I meant to suggest, Mr. Kemp, when I said this recovery has not been cyclical, in that higher inflation has not accompanied increased employment, as has been true in previous recoveries.

Mr. KEMP. A couple of years ago, 6 years ago, we were suggesting that the economy couldn't grow without inflation. Indeed, there were some that were saying that inflation was endemic to our society. In fact, people were going to extremes, suggesting that inflation was a result of democracy itself, because people wanted to live better, they wanted to live too good, and we were in an era of diminishing resources.

I think it has been astounding. We have a lot to do. You certainly have alluded to that in your testimony about cutting deficits and spending and tax reform and monetary initiatives.

Let me ask you a question that has been very much on my mind recently in watching the performance of the bond market and stock market. It seems to me there is a correlation between expectations of interest rate declines in short and long term instruments and the potential for bonds and equity markets to strengthen. To wit, we have had an incredible run up in the stock and bond market as it is now becoming increasingly clear that while 1985 was not the best year in terms of economic growth, as you pointed out, 2.5 percent, the prospects for 1986 are better.

Second, interest rates on short and long-term instruments came down significantly in 1985, despite what some people said was an increase in the deficit.

Is it possible that the reports in the newspaper of the Federal Reserve Open Market Committee meeting in December, and I think it was from the 11th to the 16th, where they suggested they might ease slightly, isn't it possible that the Fed did take steps in retrospect to allow interest rates to come down somewhat, to be slightly more accommodative, if you will, to the growth prospects, and that has had a favorable impact upon not only the economy's possible performance for 1986, but it also has a benign if not outright beneficial impact upon our prospects for a better deficit picture in fiscal year 1987?

Mr. BAKER. That is entirely possible on both points, Mr. Congressman.

Mr. KEMP. Well, in that view, in that perspective, isn't it then equally possible that rather than talking down the dollar, which has gotten us in trouble in the late 1970's, or tightening up on monetary policy, which strengthens the dollar, isn't it possible now, in your view—again, hypothetically, because you can't say exactly what you are going to do—but isn't it possible in this hypothesis that we could move right now to some zone around which the dollar and other currencies such as you helped fashion at the Plaza Hotel G–5 meeting, isn't it possible that this would be the time in which we could move toward a more stable price level, a more stable exchange rate, coordination, some agreement around some zone or reference point that would give more stability to trade, have a favorable impact upon the interest rates of the industrial world, and thus impact upon the economy?

Mr. BAKER. If you assumed, Congressman Kemp, that you were going to move to that—which I think is an assumption that at the present time is not warranted, but let's suppose you make that assumption—it would be far better to move in that direction today than it would have been to move in that direction before the Plaza Hotel meeting on September 22, because the whole point of that exercise was that the currency relationships did not really reflect the underlying economic fundamentals, and I think it is fair to say that the currency relationships today far better reflect those underlying economic fundamentals.

That was the purpose of the exercise, and in my perhaps biased view, it has had some reasonable degree of success in that regard.

Mr. KEMP. There are many of us that agree with that and looked with great favor on that Plaza accord and compliment you for the efforts you have made to get the world to focus again on the necessity for growth and the necessity for some convergence of currencies.

I really not only applaud it but urge that we take it to the next step, which is to find some reference zone around which we can look for more stability. I noticed that you said in answer to a previous question that you don't accept the idea that that is going to be done or——

Mr. BAKER. No, what I said was I think at this time it is not warranted to make the assumption that that is what we will do because, after all, I have simply been asked by the President to con-

sider whether or not we ought to have an international monetary conference to consider that possibility along with other possibilities respecting reform of the international monetary system.

And furthermore, Congressman, as you know, we have a meeting in April of the Interim Committee of the IMF to consider 2 reports, 1 from the group of 10 countries, 1 from the group of 24, on international monetary reform.

Mr. KEMP. When is the study going to be completed?

Mr. BAKER. There is no timetable. I would think it would be premature to address the question before that Interim Committee meeting was held in April.

Mr. KEMP. You mentioned that the Federal Reserve Board is doing a good job, and that is awfully subjective because no one knows, other than in retrospect, what is happening on interest rates and on monetary policy. But isn't it also possible that there was not quite as much agreement between the Fed and the Treasury Department after the G-5?

Did they agree with you that interest rates should come down here and in Japan and in Europe? I noticed that Japan lowered the discount, Germany is talking about lowering their Lombard rate. Why isn't it possible that the Fed could take a step right now and help autos and steel and exports and Third World debt problems by lowering the discount rate at this point? It would be helpful for, it seems to me, the whole economy, notwithstanding what beneficial impact it would have on the budget deficit.

Mr. BAKER. Well, Congressman, contrary to numerous press reports, there is no fundamental disagreement between the Treasury and the Fed with respect to that issue, nor has there been. I think everybody would like to see lower interest rates. The question is how do you get there and when do you get there?

I think we have got to be very conscious of the point you made a moment ago, and that is that we have enjoyed 39 months of economic expansion in this country without a resurgence of inflation, and that is, I think, a tremendous accomplishment, and we have got to be ever vigilant against the possibility of a return of inflation.

The United States is projecting higher growth than many of our trading partners abroad. We are projecting, unfortunately, somewhat higher inflation, even though it was only 3.8 percent last year. Germany and Japan are in about the 2-percent range. The third element would be that the U.S. currency is now declining while those other currencies are strengthening.

So there really is no fundamental disagreement between us with respect to doing that; the question is when do you do it and who ought to lead the charge? It is our view that the Europeans and Japan should lead the charge, not the United States.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from New York, Mr. Downey.

Mr. DOWNEY. Mr. Secretary, it is always a pleasure to see you, even if it is in a different committee.

Let me just respond to my colleague from New York, Mr. Kemp, who was quoted as saying it was an oustanding recovery in length and duration. The rate of recovery has been exactly average, 4.5

percent, and the length has been 39 months. The average length is 38 months. So it is neither astounding in its length nor in its size.

I am interested in asking you, Mr. Secretary, about the tax reform proposal that is progressing in the Senate. The Treasury apparently issued an option paper which, of course, it did not make public, but as with anything that anyone does around here, if it is Xeroxed more than once, it winds up becoming public.

In it, one of the options for the Senate Finance Committee in looking at tax reform is an oil import fee. I would like to know, Mr. Secretary, is it all right to do an oil import fee only to pay for tax reform, or would it be possible to do an oil import fee to deal with the deficit as well?

Mr. BAKER. Well, the President has made his position on that well known, I think, Congressman Downey. He didn't embrace an oil import fee. Let me start out by saying that. All he said was that he would not close the door on an oil import fee or some similar energy tax, but only as a part of a revenue neutral tax reform bill.

Let me further say that the options paper, or the paper you call an options paper, that the document you are referring to is not an options paper that the Treasury prepared—those are not Treasury-supported options. Those are a whole lot of different calculations that we were asked to run, and that's all those are. That document has no standing as a Treasury-endorsed or administration-endorsed piece of paper.

Mr. DOWNEY. Thank you, Mr. Secretary.

Let me ask you about this notion that the President says that he is firmly opposed to damaging the economy by raising taxes. Now, I understand there are problems with the Ways and Means proposal that came out, but how does increasing corporate levies not damage the economy in the tax reform plan?

Mr. BAKER. Because you get most of that out of areas that are subject to tax shelters and tax avoidance.

Mr. DOWNEY. So that the areas that—for instance, some of the changes that we have made in the depletion allowance and some of the other areas, as well as some other limitations, while it will result in higher taxes on corporations, it won't hurt in any way the productivity of those individual corporations?

Mr. BAKER. You could see damage to particular segments of the economy within an improved overall economy. For instance, subjecting real estate to the at-risk rule will, if you want to put that way, damage some people who are engaged in the real estate business who are building a lot of buildings without regard to the economic justification for those buildings but with due regard only for the tax considerations. I think that would be the answer to your question.

Mr. DOWNEY. OK. So that it's all right in certain segments. I mean some of it is abuse, clearly, and on that I agree with you completely. But you know, we are not raising $130 billion of increased corporate levies solely through abuses. I mean there are some substantial increases as well in what they will be paying.

Mr. BAKER. No, that's correct. And as you know, the administration has a problem with the House bill, in part as a consequence of that. But I ought to also say that the share that corporations pay of

total taxes has been declining substantially since 1956, as you know.

Mr. DOWNEY. Absolutely.

Mr. BAKER. And even the House bill does not bring that percentage up to the level which is the average over the past 25 years, and I don't remember the exact number.

Mr. DOWNEY. Let me develop this a little further. One of the things that you are concerned with is depreciation and the ITC. These are not narrow tax shelters, these are not limits like an at-risk rule or something else. You are interested in preserving, are you not—not ITC, obviously, but also the depreciation allowances?

Mr. BAKER. We are concerned about the depreciation provisions of H.R. 3838. We are not suggesting that we change the House bill with respect to the repeal of the investment tax credit.

Mr. DOWNEY. Yes; but one of the things about the investment tax credit is that it is not a narrow shelter. I mean it is something that you have, as the administration wisely, in my opinion, decided to eliminate, and it is going to raise a lot of money. Indeed, it is one of the building blocks of the tax reform proposal, and it is going to raise taxes on a lot of corporations and it will have an impact on the leasing equipment business and in other capital intensive industries of raising the rates, as far as they tell us. So it is clearly going to have some impact.

Mr. BAKER. I don't deny that. Many of those industries are in a negative tax position now.

Mr. DOWNEY. Let me ask you about this whole notion of the American people being undertaxed and that tax rates are essentially at the same level they have historically been. When you take out the——

Mr. BAKER. Not tax rates, Congressman.

Mr. DOWNEY. Not tax rates, but the percentage of GNP.

Mr. BAKER. Right.

Mr. DOWNEY. When you exempt Social Security, the payroll tax, from this, you find that the level of GNP has gone down from about 16 percent of GNP, which is what it was in the early sixties, to 13 percent in 1985. So is it really fair to say that as a percentage of GNP, that the amount that we tax the American people is historically consistent?

We have decided to pay for Social Security by raising the payroll tax, but we have not decided to pay for defense by raising the income tax. The American people may appear to be or may feel to be overtaxed, and that's because of the payroll tax, but when it comes to income taxes, the amount of money that goes to support the rest of Government outside of Social Security has dropped fairly precipitously over the last 20 years, has it not?

Mr. BAKER. It has dropped some. I wouldn't characterize it as precipitously, but I really do think it is fair, Congressman Downey, to look at the total charge against the economy from taxes, whether they are payroll taxes or whether they are income taxes. The fact of the matter is that the historical high has been historically around 19 percent, and that's about where it is today.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Illinois, Mr. Russo.

Mr. RUSSO. Good morning, Mr. Secretary. It is a pleasure to see you again this morning. It was always a pleasure to work with you on the tax bill.

I just have a couple of questions, Mr. Secretary. I noticed that the gentleman from New York and yourself were talking about what a great performance the economy has had over the last several years: it has reflected growth and a great recovery, there has been an increase in jobs, the inflation rate is down, and interest rates are lower.

But Mr. Secretary, I think part of the problem is the President's campaign promise to reduce the budget deficit to zero by 1984. You have accomplished a lot of things, but you still have a $200 billion budget deficit. Don't you think that the budget deficit had a lot to do with stimulating the economy and in helping create employment?

Mr. BAKER. Oh, I don't know that I would necessarily subscribe to that, Congressman Russo. I think that it may have had some effect, and clearly, a balanced budget is a promise that the President hasn't been able to keep, but he could keep it and we could keep it and you could keep it if you would simply cut $28 billion in Federal spending.

Mr. RUSSO. I don't have a problem with doing that, Mr. Secretary, but in recounting all these great things that are being done, nobody seems to mention the deficit. And a $200 billion deficit is a stimulus. If you go back to President Carter's days when the Republicans were criticizing him for a $43 billion deficit which was going to destroy the economy, then I find it kind of interesting that a $200 billion deficit that has had some very beneficial effects—I'm not for deficit spending, but it's never factored into the calculation that we talk about—I think 200 billion dollars' worth of stimulus is something to consider in determining how the administration would have performed if the deficit was zero and we didn't have all this stimulus.

You said in your testimony—and I would like to get this cleared up—that you actually cut defense spending, I believe, by 6 percent last year, if I'm not mistaken.

Mr. BAKER. The figure, if I remember correctly, is from the President's request $290 billion over 5 years as a part of the fiscal year 1986 congressional budget resolution compromise.

Mr. RUSSO. But Mr. Secretary, if I were to ask you the question, how much were outlays in 1985, would you know that number?

Mr. BAKER. Well, I can look it up for you. Defense outlays?

Mr. RUSSO. Right.

Mr. BAKER. I will get it for you.

Mr. RUSSO. I think there was about $256 billion in outlays in 1985 and I think there are $276 billion in outlays for 1986. I believe if we take the $320 billion here, it will be somewhere in the area of $300 billion.

I just want the record to reflect those are not cuts in defense spending. Those are actual increases in outlays over previous year's spending. They may be reductions from what the President wants, but in actual costs to the Federal Treasury, it's an actual increase in spending.

Mr. BAKER. We don't disagree with that. I'm talking about reductions from what the President wanted.

Mr. RUSSO. I understand that. That's a nice thing to say, because the American people believe you actually cut defense spending when in essence you have only doubled it in the last 5 years. I just want to make sure those records are absolutely perfect.

Let me ask you one last question, Mr. Secretary. Given a rank of priorities, tax reform, defense buildup, deficit reduction, in what order are those the priorities of this administration?

Mr. BAKER. There are two that we consider on the domestic side of the ledger, Congressman; they are tax reform and deficit reduction. Ever since his State of the Union Message in February 1985, the President has made the point that those are coequal priorities as far as he is concerned. Obviously, every bit as equal a priority is his defense number. He thinks that the first function of the Federal Government is the national security. That is obviously the No. 1 factor in our national security consideration.

Mr. RUSSO. Thank you very much, Mr. Secretary.

The CHAIRMAN. The gentlewoman from California, Ms. Fiedler.

Ms. FIEDLER. Good morning. In regard to the defense spending from last year, it seems to me that I recall in looking at the budget figures that in order just to remain even with last year's fiscal budget, we had to spend $18 billion more because of what was in the pipeline, committed to by the U.S. Congress, not new spending, but an already committed spending, which had been done, which was reflected in some of the spend-out, just as a point of information.

Also I recall during the course of our last year's debate, that we were talking about providing a cost-of-living increase to that group of people who were at the lowest end of the economic ladder, and at this committee, I raised an amendment which would have provided an opportunity within the Defense Establishment to provide cost-of-living increases for those people who were employed by the Defense Department, as for the most part, active duty personnel, about 60 percent of those people fall at a level economically that would be eligible for food stamps, HUD assistance and a whole host of other benefits, which the Federal Government provides to them.

Much of our defense investment, particularly in terms of the active duty personnel alone, happens to go to people who would otherwise perhaps be unemployed and be in a situation where they might be drawing upon the welfare benefits and the other economic benefits domestically, for their employment.

In addition to that, much of the defense spending is done in a way which touches the people at the lowest level of the economic ladder in the manufacturing jobs that they are a part of. Often there is an effort on the part of those who do not like defense investment for whatever their reason may be, to forget about the fact that it does supply a substantial amount of employment and as a result of that employment, it does hit people who otherwise might not be able to find employment as a result of either educational levels or economic and regional problems.

If those people who are currently employed as a result of the success in the overall economic growth that we have seen over the past few years, and I might say having come out of one of the most

serious recessions that we have faced in our modern history, if those people were not employed, what kind of a drain do you think would have been on the Treasury over the last 3 or 4 years, in terms of domestic spending programs that we would have had to invest in them?

Mr. BAKER. It would be the same kind of drain that we saw in 1981 and 1982, Ms. Fiedler, when we had tremendous increase in entitlement program spending as a consequence of the recession. We would be experiencing the same kind of phenomenon.

Ms. FIEDLER. Then we would really be in the situation, if for every 1 percent of employment increase, if my memory serves me correctly, it is something like $25 billion?

Mr. BAKER. $25 billion.

Ms. FIEDLER. Is drained out of the Treasury?

Mr. BAKER. That is right. Receipts to the Treasury are something like $25 billion less than they otherwise would be.

Ms. FIEDLER. If you applied those 9 to 10 million jobs, which have been created, and you take those benefits instead of out of the private sector through the employment and the stimulus in the economy, out of the Government sector, we would have seen a substantial increase in our deficit, wouldn't we?

Mr. BAKER. That's correct.

Ms. FIEDLER. I have an area that I'm interested in, which frankly perplexes me a good deal, relating to the International Monetary Fund and some of the other international lending agencies which make loans that support industries which are directly competitive with our domestic industry.

I would like to know what the position is of the administration on, for instance, maintaining existing IMF contributions as opposed to reducing them, and what the rationale is to maintaining it at the existing level?

Mr. BAKER. Do you mean the budgetary level?

Ms. FIEDLER. Yes.

Mr. BAKER. The rationale is basically that the United States is the world's leading economy. We have an obligation, therefore, to lead in international economic matters. Our entire free trading system depends on our ability to trade not just with other industrialized countries but with lesser developed countries as well.

The International Monetary Fund is the world's international monetary agency, if you will. It is extremely important to us as well, I think, from a geopolitical standpoint that the fledgling democracies around the world survive, particularly those south of us, in South and Central America.

I think our requests for funding the last time we were up here asking for anything for the IMF, if I am not mistaken, was 2½ years ago. The request was roughly——

Ms. FIEDLER. $8.4 billion.

Mr. BAKER. Yes; wasn't that roughly the same as the prior request had been?

Ms. FIEDLER. It was a quota increase. The previous quota increase was $5.5 billion.

Mr. BAKER. It was? In any case, that's the rationale for why we support the International Monetary Fund.

Ms. FIEDLER. I would simply like to share with you a difference of opinion on this issue. At that particular time, we were facing some very serious economic problems. We were just beginning to come out of the recession. I question that kind of international investment in direct competition with some of our own industries, particularly agriculture, where we have virtually no meaningful direct control over the spending, or where there is no clear-cut foreign policy commitments on the part of the other country, or trade agreements. I really strongly object to that kind of investment at a time that we are facing a $200 billion deficit and have to go out and borrow the money in order to do that. That is just a personal viewpoint, but one I know is shared by some of my other colleagues.

Mr. BAKER. I believe we have come quite a ways insofar as our votes in those organizations are concerned, against projects of the nature you mentioned; in particular I can speak to copper projects and that sort of thing. We are sensitive to it from that standpoint.

I think the suggestion that we would somehow pull out of the International Monetary Fund would be one that the administration clearly could not support.

Ms. FIEDLER. I don't think I am suggesting that. I'm simply suggesting that we look at our own domestic responsibility as the No. 1 responsibility of the U.S. Government, and look at the degree to which we help develop competition against our own domestic industry. This is something we have to be very cautious about, particularly in regard to the agricultural community, which is just now trying to pull itself up by its bootstraps and survive. I think that is a consideration that ought to be made.

I have one other brief point. You talked about the importance of getting a tax reform package through. We have all been working for a long period of time to try to accomplish that. I think it is very important if we want to keep employment moving up and want to keep economic growth moving up, that we do not give away some of the incentives that we provided to businesses, to encourage them to invest. We have to consider the impact that this would have on jobs.

I happen to be a strong supporter of ACRS, and I feel that we should not give it up, since in the long run that could cost us jobs and therefore, revenue.

Mr. BAKER. May I respond to that by saying that the administration's tax reform proposal called for a depreciation system which was every bit as competitive as ACRS, under which the overall cost of capital would be lower actually than under current law. It was not as competitive as ACRS combined with ITC's, but you have a number of companies in this country who are in a negative tax position. They don't pay taxes. That's wrong.

Ms. FIEDLER. That is wrong.

Mr. BAKER. There can be significant stimulus from reforming the Tax Code. We did not claim that Treasury 2, for instance, was going to result in a whole lot of extra growth. We felt it was going to result in some extra growth. We didn't make a lot of wild claims about it.

I think, frankly, that getting the top rate down to 35 percent and getting the top corporate rate down likewise will have a significant

stimulus on the economy overall, and corporations that are in a negative tax position ought to have to pay some taxes.

Ms. FIEDLER. I agree with that view.

The CHAIRMAN. The time of the gentlewoman has expired. The Chair recognizes the gentleman from Georgia, Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman. It is good to see you, Mr. Secretary. I have to go to a Ways and Means meeting shortly. I wanted to ask you two or three specific questions on the tax bill.

The Congress, both the House and the Senate, is hearing a great deal from State legislatures and counties relating to the effective date of the bond provisions of the tax bill, which has caused a great deal of problems in many, many States.

Mr. BAKER. So are we.

Mr. JENKINS. I want to ask specifically if the administration supports moving the effective date for the bond provisions for State and local governments to January 1, 1987?

Mr. BAKER. Congressman, we would support sitting down as the sense of the House resolution called on us to do with Chairman Packwood and Chairman Rostenkowski and the ranking members of both of those committees and working out an effective date agreement that would bring some certainty to the process.

Obviously, that is all it can be, simply an agreement. It would not have the force of law. We did that in 1985. I think we did it with good effect.

I would prefer, therefore, not to give you a yes or no on January 1, 1987. We would be very anxious, not only willing but anxious to sit down with those gentlemen and see if we could work out something to resolve the uncertainty that now does exist with respect to the bond market.

Mr. JENKINS. Let me ask you about two other issues. Specifically there has been a great deal of concern from both sides of the aisle about the taxation of retirement benefits of Federal employees. Under current law, Federal retirement benefits are tax free until retirees withdraw their own contributions. Does the administration support what is in H.R. 3838, which eliminates the tax free status of Federal employee contributions until they have withdrawn all of their contributions? H.R. 3838 prevents that, if you recall.

Mr. BAKER. Refresh my recollection. What did we do in Treasury 2 on that?

Mr. JENKINS. What happens today is that a Federal employee who retires does not pay any income tax upon that employee's share of contributions that have already been taxed until all of those contributions are withdrawn. That normally takes 18 months to 2 years. They then commence to pay tax on 100 percent of their retirement benefits.

Mr. BAKER. I think I understand what 3838——

Mr. JENKINS. H.R. 3838 substituted a percentage formula over the life expectancy of the employee.

Mr. BAKER. What I am having trouble with remembering is what Treasury 2 called for in that regard. That would be our position in the Senate.

Mr. JENKINS. It calls for what is in H.R. 3838.

Mr. BAKER. Then we would support that in the Senate.

Mr. JENKINS. In your statement, you indicate that you want to change certain provisions of H.R. 3838 as it deals with adequate capital cost recovery allowances. How do you recommend paying for those changes?

Mr. BAKER. The best way to pay for it in our view, Congressman, and there was a clear difference of opinion between us and the majority of the Committee on Ways and Means on this score, is to utilize some of the State and local tax deductions, which constitutes again in our view a subsidy on the part of low tax States of high tax States and on the part of low income taxpayers of high income taxpayers. That's the main source we would like to go to.

Mr. JENKINS. Would you also use the elimination of State and local tax deductibility to pay for the increase in the personal exemption?

Mr. BAKER. We would like to look to that as a primary source of revenue to correct what we see as the deficiencies in H.R. 3838 as listed in my statement, the top rate, the personal exemption, and the depreciation provisions. You can't get totally home with that even if you assumed you got it all.

That is why you have seen the President of the United States say that he would not rule out consideration—he didn't embrace it—he would not rule out consideration of some form of energy tax, if that were required to get the kind of tax reform bill that he wants.

Mr. JENKINS. The final tax reform bill must be revenue neutral. In order to provide for a full $2,000 exemption for itemizers, to provide for more generous depreciation schedules——

Mr. BAKER. You say for itemizers, at least in the low- and middle-income tax brackets.

Mr. JENKINS. And to keep a top tax rate of no higher than 35 percent, then the President would support an energy tax if additional revenue is needed to pay for these proposals; is that correct?

Mr. BAKER. No; that's not what he said. What he said when he was asked by the chairman of the Senate Finance Committee, I need to know if you would rule this out from the beginning because we don't want to go through a lot of exercise up here that would be fruitless, would you support that? The President said, Under no circumstances would I support that. The chairman asked, Would you support some form of energy tax if it were required to get a revenue neutral tax reform bill of the nature that you want? The President said, I wouldn't close the door on that. The President certainly has not endorsed it. He hasn't said he would take it. He simply said, I would be willing to consider it.

Mr. JENKINS. I understand that. You and I are both in agreement that the elimination of the deductibility of State and local taxes alone will not pay for these three things.

Mr. BAKER. If you got it all, you would come very close. You would get $100 billion if you got it all. I don't think it is reasonable to think that we could get it all, nor do you, obviously. You could get very close, Congressman.

Mr. JENKINS. Assuming that we don't get it, which you and I would agree that we would not.

Mr. BAKER. Get it all.

Mr. JENKINS. At that point, what I want to know is does he support an energy tax to make up the difference?

Mr. BAKER. He would look at it at that point, but he would like first to see if we could get it from the State and local deduction and——

Mr. JENKINS. We will not.

Mr. BAKER. Perhaps in other ways.

Mr. JENKINS. What other ways?

Mr. BAKER. There is $75 billion in revenue raisers that were discarded in Ways and Means, for one reason or another. It may be that the Senate would be willing to utilize some of those.

Mr. JENKINS. 401k's?

Mr. BAKER. You know what they are. There are 75 billion of them.

Mr. JENKINS. Thank you, Mr. Secretary.

The CHAIRMAN. The Chair now recognizes the gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you, Mr. Chairman.

Mr. Secretary, I enjoyed, as I am sure you did, the article in the Sunday Post on your approach and style to the job that you currently hold. I was particularly impressed by a quote from one of your staff people, perhaps a former staff person, about how you view these hearings as symbolic and not substantive.

I happen to agree with you, and I want to say that I think that you participate in this ritual with about as much candor as anyone representing the administration at the present time. I want to thank you for that. But I have to be candid with you and say that I think we have overlooked a major problem for a lot of people in my district, a lot of people across the country, who are very much caught up in the disastrous trade deficit that we currently face, $150 billion this year, even with the effective effort that has been made to buy down the dollar's value. We anticipate perhaps $100 billion in the next year. That is with a 12-percent reduction in the value of the dollar.

What do I tell my highly efficient high-technology industries and farmers in California when they wonder what will be the followon to this initiative? We look at the G-5 meetings and we see, except for a slightly more stimulative monetary policy in Japan, very little action on the part of our developing countries, or developed countries, economic activities. There is very little change that is going to mean more consumption of our products or more fairly balanced currency system internationally.

Mr. BAKER. Well, I think one thing, Congressman, you could tell them is they are not looking at a 12-percent reduction in the dollar, they are looking at a 32-percent reduction against the mark since this time last year.

Mr. FAZIO. I am talking about a marketbasket of currencies, now.

Mr. BAKER. Well, even with a marketbasket, it's, I think, greater than 12 percent. The two principal currencies, you know, are the mark and the yen, and we are looking at 32 percent against the mark and 29 percent against the yen since last February. So, those are substantial reductions.

I would tell them further that those reductions don't show up in the trade numbers, for 12 to 18 months, that we are only 12 months away from the high of the dollar last year, as my state-

ment indicated, we ought to begin to start seeing some improvement. I think we will. But it does take 12 to 18 months.

And finally, I think I would tell them—and again, I'm still answering Congresswoman Fiedler's question—I would tell them that it would be a terrible mistake for the United States to decide it was going to, in effect, go it alone, it wasn't going to have anything to do with the IMF or some of these other multilateral institutions that do help us preserve the world's free trading system, because we will never develop markets for our goods abroad if we walk out of those—participation——

Mr. FAZIO. You're preaching to the choir here. I realize you have trouble keeping your troops in line on the IMF issue at times, but I think the real problem that we face is that we are concerned about increasing depreciation of the value of the dollar. What other policies can we envision that are really going to bite into our trade imbalance?

You know, we were the largest creditor in the world in 1982, and today in 1985, we are about to be the largest debtor. That is a pretty dramatic shift in 3 years. I'm wondering whether or not we can sustain this kind of international debt, particularly as we note that some of those creditors that we still have are in terrible shape as a result of the oil price drop.

Mr. BAKER. Well, that's true, and the oil price drop has had a significant detrimental effect on some oil exporting debtor nations. On the other hand, it has had a tremendously beneficial effect on many other debtor nations, so on balance I think there would probably be more good there than bad. But I think that the fact that we have seen this dramatic drop, but we haven't seen the results of it yet, is the primary argument you have to use with it, because that is what is going to cure the——

Mr. FAZIO. So, just hang on and wait, basically?

Mr. BAKER. Well, this has all occurred—most of this has occurred since September 22, and it does take 12 to 18 months. But I think another thing you can tell them is that the worst thing we could do is walk down the same path we walked down in the 1930's when we decided we were going to be protectionist, and we had Smoot-Hawley, and we all saw what that led to.

Mr. FAZIO. Well, I realize you're on the cutting edge in fighting the protectionist tendencies that every Congress will have, but what are we really going to do to protect ourselves from the inevitable day when the money starts to flow home, the money that we have in effect borrowed from overseas lenders to sustain this recovery and to keep it, as you have indicated, on this lengthy but gradual upslope? What happens when the day comes when that money starts to return home and we begin to see a tightening effect on the available capital in this country and interest rates inevitably start to go up?

Mr. BAKER. Well, if that should happen——

Mr. FAZIO. Don't you think it's inevitable?

Mr. BAKER. No; I really don't, Congressman. I don't think it's——

Mr. FAZIO. Well, then you don't worry about our status as a permanent debtor.

Mr. BAKER. I was about to say, I really think that there's too much made of our status, the fact that we are becoming a net

debtor nation. The question is not whether you are a net debtor nation, but what you're using the money for. And if you are using it for investment, and if you are using it for economic expansion, as we have been using it for, and productivity and that sort of thing, I wouldn't worry about it. We were a net debtor nation for 200 years in this country and we got along very, very well. So, I don't think that fact standing alone is necessarily all that adverse. It's a question of what you do with the money.

The CHAIRMAN. Excuse me, Mr. Secretary, before I yield to Mr. Goodling—it is his turn—I was distracted for a moment. I want to just make sure I heard you correctly. Did you say that our becoming a large debtor nation was not a major problem?

Mr. BAKER. What I said was I don't see it as a catastrophe, as some have suggested. It's a problem only if that money is not used in productive ways, and we have basically been using it productively, in a productive way. We were a net debtor nation for 200 years, Mr. Chairman, and we got along very well during those 200 years.

The CHAIRMAN. I just wanted to make sure that I heard.

Mr. Goodling, the gentleman from Pennsylvania.

Mr. GOODLING. Thank you, Mr. Chairman.

Mr. Secretary, I am happy to see you in the position you are in. I also wish to compliment you on the position you had before you got to this one, both of them, and I guess it proves that you do well in any leadership position that we chose to have you serve.

I would like to first comment, the gentleman from Illinois spoke a great deal about Jimmy Carter's debt and President Reagan's debt, and I think that if we really want to lower our stature as statesmen or statepersons, that's the way to do it. Because the public is getting sophisticated enough now that my constituents know that Jimmy Carter didn't have a debt; the Congress of the United States had a debt. They know Ronald Reagan doesn't have a debt, that the Congress of the United States has a debt. Both sides can be blamed. It's a 2-to-1 majority in the House, it's a Republican majority in the Senate, so that kind of rhetoric just about drives me up the wall as I sit through these meetings day after day. And as I said, thank goodness the public is becoming more sophisticated and they understand who is responsible, and they know it is the Congress of the United States.

I was also going to ask him whether he thought the high interest rates had anything to do with that deficit. The one question that I wanted to ask you, Mr. Secretary, and I guess Mr. Jenkins has pretty well milked to death, I happen to believe that the one, the outstanding part of the tax program that was sent up to the Hill by the administration, was moving the $1,080 to $2,000.

I think if you really want to help low- and middle-income working Americans, that's the way you do it. If you want to do something constitutionally about helping people in private and parochial schools, that's the way you do it, not through any other kind of legislation. And so I was extremely pleased with that.

In fact, if that's the only thing you had sent up the Hill, plus trying to find a way to make up for what you have lost by doing that to the Treasury of the United States, I would have been very, very happy. I am not happy with what has happened in the House in relationship to that $2,000.

I guess I would just pursue a little what Congressman Jenkins was asking. I think he pretty much indicated to you that there is not a snowball's chance in Hades, apparently, of making up that lost revenue by the elimination of the State and local tax deduction issue.

Mr. BAKER. Not a chance of making all of it up.

Mr. GOODLING. Yes; well, I got the impression Mr. Jenkins was saying that there's not much hope of making any up through that route. But, at any rate, do you have other ways, other ideas to go with that effort if, you can only make part of it up that way? Or if you can't make any of it up? Because, again, I think it's the most significant part about the whole tax bill.

Mr. BAKER. Well, Congressman Goodling, there are basically three ways to cure 3838 in a way that would make it acceptable to the administration along the lines of my statement. That is, get the top rate down to 35 percent, provide for the full $2,000 exemption, and fix the depreciation provision, among a few other things.

The three ways to do that are to utilize the State and local tax deduction, and that's $100 billion in the aggregate; or to utilize some of the $75 billion in other revenue raisers that were discarded during the process in Ways and Means; or turn to a new revenue source. Those are the three ways to do it. They are all three, to varying degrees, available.

The President has not ruled out, as I discussed just a moment ago with Congressman Jenkins, looking at some form of energy tax. He hasn't embraced it. All he said is he would not close the door on it, if such consideration would be required in order to get a tax reform bill that he liked.

Mr. GOODLING. Let me then ask one other question. If the way to get to the $2,000 across the board means that the 38 stays at 38, I could not give a hoot whether it gets moved from 38 down to 35. If you move me from 70 to 50 to 38 percent, I am going to say thank you, ma'am, and that is it.

If it comes to that kind of thing, how do you think the President will stand on that issue, if he has to negotiate not below the 38 percent in order to get the $2,000?

Mr. BAKER. Well, I do not think that—I guess what you are really asking me, does he view all of those sine qua nons as equal, and I would have to tell you he does.

Mr. GOODLING. He does.

Mr. BAKER. He thinks that the top rate is very important. He thinks the $2,000 exemption is very important. He thinks the depreciation provisions are very important.

Mr. GOODLING. OK. He also knows that the Congress is very important, and I guess I should not ask you, because you cannot really speak for him, but it seems to me there is going to have to be some negotiating between those three issues in order to get a tax bill passed through the House of Representatives after the Senate is finished.

Mr. BAKER. Well, obviously we are only—as I continually remind people—we are only at step 2 of what could be a long process. I guess we are at step 3, if you consider Ways and Means as 1, and the House floor as 2, and the Senate Finance Committee as 3. So we are at step 3 in a 5-stage process.

Mr. GOODLING. Thank you. I have no other questions.

The CHAIRMAN. The Chair recognizes the gentleman from Florida, Mr. MacKay.

Mr. MACKAY. Mr. Secretary, I share Mr. Fazio's comments. I very much appreciate what you are doing, and I wish there could be two of you, so I want you to understand I am not approaching this question process from an adversary standpoint.

I do want to talk in terms of your economic projections. I want to pose a hypothesis and get you to respond to it. The largest economy in the world, for reasons that have to do with an impasse on domestic policy, is amassing deficits on a domestic and international level on a scale heretofore unimagined. The rosy view in the stock markets and bond markets is related in part to the Fed's apparent willingness to go to an accommodative monetary policy. So in what I believe is an historic first in peacetime, we have an expansionary fiscal policy and an expansionary monetary policy at the same time. Our agricultural sector is on the verge of collapse. Many of our industries that are involved in international trade are in trouble. The international debt situation is unprecedented. The health of our financial system is related in large part to the outcome of those problems. If either of those go wrong, we could have an international run on the dollar and a major problem with our banking system that would make the 1930's look mild.

An oil price drop, as you pointed out, could be good and bad.

I want to pose this hypothesis. The doom and gloom days are over. Stockman is gone, your own former Assistant Secretary said that. Kanes is gone. Murphy is not gone. Murphy's law has not been repealed. Anything that could go wrong will go wrong. We are in an extraordinarily risky and unprecedented situation.

In part it is working because of you and in part it is working because of Paul Volcker. That is my assessment of what is going on. It is a situation that exists because of international confidence.

The hypothesis is this: What if Murphy's law grabs us? What if the oil price drop on balance turns out to be bad as well as good and we have a debtor's moratorium or an international run on the dollar? I don't want to think about those things. It is strange for a Democrat to be posing this hypothesis to a Republican. In fact, it should make you more nervous than me.

What if that happens? It appears to me that the only option would be for Volcker to raise interest rates. That is what is happening in every other country. That is what is happening now in Britain.

Two questions; haven't you discounted these risks to zero in your economic projections, and wouldn't we be better off with economic projections that better reflect the riskiness of the current economic situation?

Mr. BAKER. Congressman, I was asked the question earlier, and perhaps before you got here, about the assumptions. I think the chairman asked me.

I think the administration's assumptions are very, very reasonable. They are looking even better, as a matter of fact, as a consequence of the oil price decline. The fact of the matter is that most private economists were projecting 3 percent growth, we are pro-

jecting 4, and now they are revising their estimates upward closer to ours.

So I just don't see that we are at all involved in a rosy scenario situation with respect to our projections.

I also mentioned earlier that we missed our assumptions in 1982 and 1985 on the high side, but we were low in 1983 and 1984. The assumptions game is not an exact science. There are going to be some fluctuations, and I really don't think this business that our assumptions are wrong or too rosy will wash.

I mean sure, you won't come in exactly right on the numbers. You never do.

Mr. MACKAY. Mr. Baker, let me put it a different way. One of the consequences of the conflict of interest laws are that people who serve in high positions in the executive branch put their assets in a blind trust. Do you believe that the people that are investing the assets of the top people in the Reagan administration share the rosy view of the people who are making the policy decisions?

Mr. BAKER. I think they do with respect to the assumptions this year, yes, sir. I mean I have got to say it one more time. These are not rosy scenario assumptions, in my opinion.

Mr. MACKAY. I grant you that in the short term it appears that what has happened is consistent with what you are saying, and I grant you that for 1 year and maybe 18 months, a reasonable person would perhaps raise those projections. Where do you discount the risks? Where do you take into account the risks, and do you not, as you go out into the 3rd and 4th year, have to put on a set of blinders and pretend that nothing could possibly go wrong when the history of the world is, in every situation, including the last time the stock market reached this kind of historic high, somebody nobody counted on went wrong. Murphy triumphed.

Now, where is Murphy in the Reagan administration?

Mr. BAKER. Well, I tell you where I think—you are saying where have you discounted the risk and that sort of thing. I think we have discounted it by coming in with very realistic assumptions.

The suggestion was made to me in the Senate Budget Committee yesterday that our assumptions were too low, and that in light of the oil price drop, we could revise our growth numbers upward, and then we won't have nearly as big a problem dealing with this deficit.

Mr. MACKAY. I would feel much more comfortable if what you were saying this year was not so contrary to what the Reagan administration said last year, and if I didn't know that nothing much has changed except an oil price drop, which has a down side and an up side, and an accommodative fiscal policy, which the Reagan administration theoretically didn't have much to do with.

Mr. BAKER. I think a lot has changed. If you look at the leading economic indicators, if you look at the rate and pace that unemployment is declining, if you look at industrial production—I mean I could cite a lot of numbers in terms of what is happening to the economy, but again, Congressman, I do not think that we can be accused of adopting a rosy scenario approach.

Now, you suggest that perhaps it's rosy in the long term, and let me just tell you that the law requires us to come up here with these 5-year estimates and projections, and nobody in this room

can make a very good guess with respect to what is going to happen 5 years out. That is just a fact of life.

But I certainly would agree with you that our assumptions over the 18-month to 2-year period are eminently reasonable, and we have people over in the other body suggesting that they are too low.

Mr. MACKAY. Well, that doesn't necessarily discredit my argument.

Mr. BAKER. No, that's what makes horse races.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from South Carolina, Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Secretary, we are delighted to have you before the committee this morning. I am sorry that Mr. Goodling left because I was getting ready to drive him up the wall.

You know, I want you to follow along with me just a minute because I am having a very difficult time following some of the things. You have said two things this morning. You know, you have the reputation, and I am sure it is well deserved, of being an extremely bright person, and I just cannot figure this out.

You have made the statement, No. 1, that the $200 billion deficit that we are running is inconsequential as far as the stimulation of the economy is concerned.

Mr. BAKER. No, sir, I didn't say that. I said I am not so sure that you can prove that they have had all that big a stimulative effect. I didn't say they were inconsequential. I'm just saying I don't think——

Mr. DERRICK. Mr. Baker, you can say it your way. I think we are both saying the same thing. I think what you have just said is that it is not a big factor, at least.

And you have also said that it is not that consequential that we have become the largest debtor nation or are about to become the largest debtor nation in the world. I would agree with what Mr. Goodling says, that there is enough blame to go around for Democrats and Repulicans, Jimmy Carter, Ronald Reagan and all that, but I fail to see what we have to stand on top of the barn and crow about.

You know, the deficit in this Nation in 1979 was somewhere in the neighborhood of $29 to $40 billion or somewhere in that neighborhood, depending on how you want to figure it. Now, today it is running $200 billion. We have had a substantial increase in jobs since 1981, that's true, but it is nothing that has been just spectacular, nothing that has substantially exceeded what we have done before. And at the same time, we are running this tremendous trade deficit.

It seems to me that it kind of reminds me of a drunken sailor on Saturday night that you give $500 or $600 to to go have a good time, and they are going to have to repay it on Sunday morning. We are kind of in that period now, and it seems to me that what we are doing is borrowing this prosperity that we are going through.

I'm not putting all the blame on the administration or the Democrats or the Republicans or what have you, but I think it's just a fact. I mean Paul Volcker sat in that very seat that you are sitting

in last year and told us that it wasn't a matter of whether it was going to happen, it was just a matter of when it was going to happen if we continued with these $200 billion deficits.

Now, I know you said earlier in your remarks that the President's top priorities were deficit reduction and something else. I have forgotten what it was. But that was one of his two priorities. He is 5 years into his administration. It's nice to talk about that now, but I don't see anywhere we are going but toward catastrophe.

Maybe Murphy's law is still in place, but I will suggest to you as well, Mr. MacKay, that Keynesian economics is still in place. What is going to happen is that one of these days before too long, at the rate we are going, these foreign funds are going to be pulled back home, and I think the price of oil may have a substantial impact on that, and what are we going to do to stimulate this economy? We are going to do the same thing that we have always done. We are going to pump more money into it.

We are pumping $200 billion into what is supposed to be a good economy, a strong economy, so what are we going to be talking about here 4 and 5 years from now, $400 billion and $500 billion deficits? Tell me I'm wrong.

Mr. BAKER. You're wrong. [Laughter.]

Mr. DERRICK. All right. Now tell me why. Tell me why.

Mr. BAKER. Let me tell you why. First of all, I want to make certain that you didn't misunderstand me. I have never once suggested, nor would I, that deficits don't matter. Deficits do matter. The deficit, in my view, and I have testified to this effect over the course of the past year many times, is like a cancer, and if we don't get it, it is going to get us. We have got to do something about it.

It, the fiscal year 1987 current services deficit estimate, doesn't happen to be $200 billion, however. It happens to be about $180 billion, and I think we ought to be pleased.

Mr. DERRICK. Well, that makes a whole lot of difference. My whole premise just goes out the window because it is $180 as opposed to $200 billion. The fact of the matter is that it's $180 to $200 billion.

Mr. BAKER. No, all I'm suggesting is that we ought to be accurate in our figures, and that is not only our estimate, but yours, as well, the Congressional Budget Office's, as well.

The way to avoid catastrophe, if I may say so, Mr. Derrick, is to pass the President's budget. You can do that. All you have to do is cut about $23 billion out of Federal spending, and you will be at zero in 1991. That is what the President is asking that you do.

Mr. DERRICK. Is that based on Congressional Budget figures?

Mr. BAKER. Yes, sir, $23 billion, and here is how——

Mr. DERRICK. The figures that I have seen indicate that he is at least $20 billion off on the deficit the first year, and it multiplies up to $60 or $70 billion.

Mr. BAKER. Well, that's not right. The argument has been over defense outlays, and it is about $14 billion, and the fact of the matter is we will control the amount of outlays because the executive branch has control of that.

But really, you know, at Christmastime we were talking about Gramm-Rudman in terms of $50 and $60 billion that would have to

be taken out by way of sequestration, and now we are talking about $38 billion. That $38 billion is composed, Mr. Derrick, of the following: $6.3 billion in revenue increases. A lot of people want to see us raise revenue. It's a lot easier than cutting spending, and I understand that. The President is coming up here and saying, fine, put $6.3 billion in there as a revenue increase.

There is about $3 billion in sales of assets, which is not cutting spending, about $3.6 billion in other offsetting collections and interest saving, and $2.7 billion out of the defense top line based on the 1986 congressional budget resolution.

So what you are really talking about is cutting about $23 billion out of domestic spending programs, on which we would spend $418 billion in fiscal year 1987.

Mr. DERRICK. I'm not talking about what we are going to do in the future; I'm talking about what you did in the past, which is nothing. I mean what sort of economic accomplishments can the administration stand up and crow about when you have a $200 billion deficit? Your rate of recovery, your rate of capital expenditure, your rate of jobs has not been anything exciting. It was done with a lot less deficit back in the seventies when we pulled out of the 1974-75 recession.

I understand that you can tell me what you are going to do, but I want you to tell me is what you have done.

Mr. BAKER. OK, let me tell you what we have done. We have taken inflation from 12.4 percent, which is what it was when we came into office, down to under 4 percent per year for 4 years. We have taken the prime interest rate from 20.5 percent, which is what it was the day we——

Mr. DERRICK. But you haven't taken the real interest rate. The real interest rate is as high as it has been in history today, and that is what counts.

Mr. LOWRY [presiding]. The gentleman from South Carolina's time has expired. The gentleman from Colorado, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Secretary, as I understand the numbers, inflation has dropped from 12.5 percent to near 3.5 percent. The prime interest rate was 21.5—and is down to 9.5. I understand the gentleman's point about real interest rates, but I think you will find there is a drop there, as well.

It seems to me employment has gone up dramatically and unemployment has gone down. You may be criticized, but that is a pretty fine record.

I just would like to say how much I think the folks who have had a chance to deal with you as you were chief of staff appreciated your cool hand at the wheel. We are looking forward to working with you in your new position.

I did have several questions I would like to invite you to comment on. What are your thoughts on the likelihood that Mexico has any chance to pay their interest. What do you rate as the prospects of Mexico meeting its obligations?

Mr. BAKER. It is obviously a tougher problem for them now as a result of what has happened over the course of the past 3 to 4 weeks, but we are having discussions within the executive branch about possibilities in that regard. As far as we know, they are

having discussions down there. The multilateral institutions are taking a look at the situation.

It is a little difficult, Mr. Brown, for them to know and for us to know until we determine where oil prices are going to settle at, and we don't know that yet. So until you really know where they are going to settle at, you don't know what the shortfall is going to be.

But I think there is a lot of room for action on their part that would be designed to open up that economy down there. They have done some things over the course—and I'm not talking now about austerity type measures. I'm talking about privatization and I'm talking about encouraging foreign investment and doing some things that don't necessarily—freeing up, for instance, their financial sector—things that don't require austerity.

I can't put a percentage on it for you. All I can tell you is that I don't think it's a hopeless situation by a long shot. It is more difficult, indeed, than it was a month ago, but I said earlier on, and again, it may have been before you got here, that I think the oil price drop on balance is going to be much more beneficial to the world economy than it is going to be detrimental. It will clearly be detrimental to a nation such as Mexico.

I think that all the nations of the world should be alert to that problem and indicate a willingness to work on it. Mexico has to lead the charge, though, and they have got to be willing to address some fundamental economic reforms that I think are required if they are ever going to be in a position to earn their way out of their current debt status.

Mr. BROWN. I understand the United States obviously has an interest in what our banks loan overseas, obviously because of our involvement in the World Bank, the International Monetary Fund, the FDIC that guarantees deposits, and the Currency Stabilization Fund that you have some control over. It strikes me that in an historic perspective we may well decide that it probably wasn't the brightest idea in the world to loan huge amounts of money to foreign countries unsecured.

Mr. BAKER. I don't think we have to wait to make that decision.

Mr. BROWN. You understand my concern. I was a bit dismayed at the press reports that attributed statements to you that indicated some interest in having them loan even more money.

Mr. BAKER. Mr. Brown, perhaps you do not understand what the initiative that we advanced in Seoul, Korea really does. We first set the condition that those nations that are indebted, the principal debtor nations must be willing—and this is the sine qua non of the whole proposal—they must first be willing to adopt economic reforms such as the kind of economic measures that the President of the United States has brought to this country, growth-oriented, free market type economic reforms that would permit them to earn their way ultimately out of debt. If they were willing to do that, the private creditors who already have substantial exposure in those debtor nations should at the same time guarantee, then, that there will be additional capital flows to sustain those countries through those economic reforms. That is all I suggested.

Mr. BROWN. That is very helpful, and obviously a far different position than the press had summarized, at least in some reports.

Mr. BAKER. And I have said on other occasions in testimony up here on the Hill that this is not a bank bailout proposal in any way, it's not an arm-twisting exercise. The banks are going to participate if they deem it to be in their self-interest to do so. It's not unlike domestic credits that go bad. Many times you improve a domestic credit by getting the borrower to agree to change his ways, against which you agree to assure him of additional capital flows, and you make a bad credit into a good credit. That is the rationale behind this.

Furthermore, I want to make sure you are aware of the fact that we are not asking the Congress for any additional budgetary exposure in connection with this proposal. We are seeking to utilize presently underutilized capacity of the World Bank, the multilateral and the Inter-American Development Bank, and additional private flows if, again, those private lenders see it as in their best interest to do so.

Mr. BROWN. I have over the past few years had an opportunity to chat with some folks who had the pleasure of being audited by the IRS. I'm sure you have had that pleasure from time to time also.

Mr. BAKER. Every year for a long time.

Mr. BROWN. One of the very legitimate concerns I have had expressed to me, or at least seemed to me legitimate, was people being audited by mail, being given a deadline to respond, and not being given any way to talk with the auditor. In other words, in the Colorado area we are audited out of the Utah Center, the Ogden Center. No one in Colorado is authorized to talk with them about the audit. There is no phone number made available in Utah to talk to, and written requests to talk to someone so they can even understand what is being demanded are not responded to. Their written requests for an opportunity to chat with someone are simply answered by demands for cash.

Mr. BAKER. Excuse me, Congressman. In the letter that comes back with the audit information, there is not a name of a person and a telephone number on there that the taxpayer can call? I'm very surprised at that. We will take a look at that right away and get back to you.

Mr. BROWN. I am sure you would be sympathetic. I think that is a reasonable kind of thing. If you could, I would appreciate it.

Mr. BAKER. Absolutely. We will take a look at it and get back to you.

Mr. BROWN. Thank you.

Mr. LOWRY. The gentleman from Massachusetts, Mr. Atkins.

Mr. ATKINS. Thank you.

Mr. Secretary, yesterday before the Senate Budget Committee, you indicated that the Treasury Department has an ongoing study of tax amnesty. You also indicated that you felt there might be some short-term benefits but a long-term detriment to the voluntary tax system because some people would be tempted to delay paying taxes.

I am just curious, in light of the experience of 18 very different States in this country, with tax amnesty and also particularly the experience of some of the States that now have 3 years under their belt of tax amnesty, where you see the down side on a tax amnesty program?

Mr. BAKER. I hope I said before the Senate that it was the view within the Department that there might be a long-term cost. Frankly, the report hadn't come to me. I meant to say, if I didn't, that I was expressing a staff view; the report hadn't come to me yet. It is something that I think I also said we were actively looking at because we had been requested to do so several months ago by Senator Dixon.

I think the difference, Congressman, is the Federal Government generally speaking has better compliance levels than State governments. The expected gain initially is perhaps less. Your State has had an excellent experience, I think, because you have combined your amnesty with a substantial compliance program in addition.

Mr. ATKINS. I would agree with you. I think that is critical. Tax amnesty alone would have significant problems, I think.

Mr. BAKER. That's correct. We have some compliance initiatives going now. We have an initiative in fiscal years 1987, 1988, and 1989 budgets, which relate primarily to additional agents. This is something that we are going to take a serious——

Mr. ATKINS. When do you expect to have some results back and some recommendations for the Congress and for the Ways and Means Committee as a result of that study?

Mr. BAKER. I don't think we have a particular time in mind. I would like to get it completed as soon as possible. If the reservations that the IRS and our tax policy people have about the long-term effects of it, turn out to be dominated by the short-term gain that would be realized, obviously, the net gain would be helpful. A lot of people are looking at that very covetously in terms of deficit reduction, I am sure. We will finish the study as soon as possible.

Mr. ATKINS. One of the concerns I had was you put, and I commend you for it, funding for 2,500 new agents in the budget this year. You estimate $900 million in the first year as additional revenue and I believe $7 billion over a 3-year period. I am wondering why you were not more aggressive in your recommendations for new resources for the IRS if you are getting that kind of return?

Mr. BAKER. Congressman, this was something designed and submitted 2 years ago; it came into the budget process 2 years or so ago. It cost a little money to put those agents on to begin with. You do not see the return immediately.

My recollection is it is going to cost us about $500 million but we are going to pick up over a 5-year budget period, $4.7 trillion. I believe those numbers are accurate.

Mr. ATKINS. Wouldn't it make sense——

Mr. BAKER. I'm sorry; $4.7 billion, $500 million.

Mr. ATKINS. Wouldn't it make sense given that kind of return—for most of us, that is a good investment. Wouldn't it make sense to be more aggressive in those recommendations?

Mr. BAKER. 2,500 new agents a year is pretty aggressive, Congressman. You have to staff up and provide administrative support and all the rest of it. I think in and of itself, it is a pretty aggressive initiative.

Mr. ATKINS. Thank you.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Minnesota, Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Mr. Secretary——

Mr. BAKER. May I just say the $500 million, $4.7 billion figure is a 3-year figure. I think I mentioned it as a 5-year figure.

Mr. WEBER. Mr. Secretary, I want to talk a little bit about monetary policy and I want to preface my remarks by saying I think that monetary policy and international exchange rates and those problems are the most important work that you are addressing yourself to, and also I want to say I really think you are doing a spectacular job there, such a good job that it is a shame you have to be diverted by this tax reform issue. I do think you are doing a good job on the monetary issues.

Mr. BAKER. Thank you very much, Congressman. I am going to be diverted by whatever issue interests the President.

Mr. WEBER. I understand. I guess my views on that subject run quite contrary to my colleague from Florida, Mr. MacKay. I question whether or not monetary policy really is so expansionary. We know there is a strange and mysterious relationship between the Department of the Treasury and the White House and the Fed. I am interested in your views on it.

In my part of the country, we are in a state of economic depression, the agricultural parts of the country, forced on to us, because we have experienced deflation over the last several years, deflation of commodity prices, a 60-percent deflation of land values in my district, somewhat less than that, but still substantial across the country as a whole. If you look across the board, other commodity prices also have been falling, forest products, precious metals, the oil prices recently.

If you look at interest rates, although the real rate of interest has come down recently, it is still some 5 to 6 percent above the inflation rate, which by historic standards would be indications not of a loose or expansionary monetary policy, but still of a fairly tight monetary policy.

That is my view. What is your view? Do you think monetary policy is too expansionary or about right?

Mr. BAKER. As I said in my statement, Congressman Weber, I think the Fed has done a good job. I think the Fed is doing a good job. I started to say in my answer to Congressman MacKay—I started to make the point you just made—that labels are misleading. What is expansionary to one person is constrictive to another. I do not like to use those labels. I think the Fed has done a pretty good job. I also testified earlier to the effect generally that all of us would like—I would include everybody at the Fed in this—lower interest rates. We don't want to see it obviously, at the cost of higher inflation.

Some would argue there is no risk of that when you are looking at a producer price index number change of minus 0.7, such as we saw here recently, or when you are looking at oil prices dropping as far as they are moving down.

I think they are going a good job. It is a tough job. Everybody, from time to time, I suppose will have disagreements with where it comes out.

Mr. WEBER. One of the problems that we have in analyzing what the Fed is doing or at least that I have, is the criteria that they

seem to use, on which they base their monetary decisions, shifts so dramatically.

Mr. BAKER. I understand.

Mr. WEBER. They started out in this administration with a fairly strict monetarist approach, just judging the quantity of money. I think that approach has largely been discarded. At some time, the chairman will indicate that commodity prices play a major role in his decisionmaking, other times it is GNP growth. What do you think should be the major criteria that the Fed looks at when they——

Mr. BAKER. I told the Senate committee yesterday that I consider myself to be rather eclectic in terms of monetary policy. I think you ought to look at a wide range of factors. I don't think you ought to just look at one single indicator or factor. All of the factors you mentioned, in my view, are appropriate to consider.

Mr. WEBER. I guess I agree with that. Let me look at the international situation, because for many of us that represent agriculture districts and other export oriented districts——

Mr. BAKER. Excuse me, if I may add to that answer. I agree with you that I think the Fed is looking at several factors, that they are not limiting themselves to just one single factor.

Mr. WEBER. The President in his State of the Union Message said he was instructing—maybe Congressman Kemp already discussed this—he indicated you were going to be reporting back to him on the appropriateness of an international conference to discuss the whole question of exchange rates. When do you expect to report to the President? What can you tell us about your current thinking on that? What might cause you to report back to the President that it is not appropriate to have that conference?

Mr. BAKER. I don't think it would be appropriate to express my present thinking in advance, as I mentioned to Congressman Kemp, in advance of the meeting of the Interim Committee of the IMF which is going to take place here in April.

We have two monetary studies on tap to be considered at that time by all the nations that are members of the International Monetary Fund. I don't think it would be right or fair for the United States to in effect prejudge that or in some ways preempt that.

As to the timetable; I think I also volunteered in an answer to Mr. Kemp that there is no timetable—the President didn't give me a timetable. I don't think it would be appropriate to address the problem before that Interim Committee meeting is held.

Mr. WEBER. What is the date of that?

Mr. BAKER. That is in April, some time. I'm not sure exactly when in April.

Mr. WEBER. Do you think you will report this year?

Mr. BAKER. I think there would be a good likelihood that we would. Again, I would not like to be constrained. The President didn't put me under a timetable and I don't want to put myself under one. Who knows what will happen. We may decide to do it later on. Right now, I would think we would report this year.

Mr. WEBER. I appreciate what you are doing there. I think it is very important. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Michigan, Mr. Wolpe.

Mr. WOLPE. Thank you very much, Mr. Chairman.

Mr. Secretary, let me join in the accolades that have been paid to you earlier. I don't think the administration has a more effective or candid witness that comes before this committee. I certainly do appreciate your performance. I sense from some of my colleagues, especially those from the other side of the aisle, that for that reason they perhaps would like to have you back in your old job rather than the one you are occupying right now.

Mr. Secretary, on October 16, 1985, the Synthetic Fuels Corporation signed a contract giving $500 million in assistance to the Union Oil Co.'s Colorado oil shale project. Section 131(g) of the Energy Security Act requires the SFC to formally consult with the Department of the Treasury prior to the awarding of contracts.

On October 17, 1985, and I have the entire wealth of correspondence here, you wrote to the SFC to indicate that the required consultation had not taken place. On October 18, Mr. Noble, the chairman of the SFC board, acknowledged in a letter to you that the required consultation had in fact not taken place. On October 29, 1985, in another letter to the Synthetic Fuels Corporation, you indicated, and I quote, "We cannot agree with your contention that the agreement by which financial assistance would be awarded to Union has become a general obligation of the United States, backed by its full faith and credit, and incontestable in the hands of the holder."

In short, you indicated, and I think correctly, that what you described at one point as the purported $500 million contract with Union Oil Co., was not in fact a legally binding contract because the Treasury Department had not formally consulted with the Synthetic Fuels Corporation prior to its award.

On December 19, 1985, Public Law 99-290 was signed into law by the President, abolishing, as you know, the Synthetic Fuels Corporation.

Mr. BAKER. What was the date of that?

Mr. WOLPE. December 19.

Mr. BAKER. In between those dates, was there not a——

Mr. WOLPE. There was a December 19 letter——

Mr. BAKER [continuing]. Did not consultation occur between that——

Mr. WOLPE. That's correct, but the contract in question was entered into without consultation. The December 19 letter is irrelevant in that the agreement that the SFC entered into contractually was entered into without the consultation, which both you had indicated had not occurred and which they acknowledged had not occurred. I don't know the relevance of the letter to which you are now referring.

On December 19, that bill was signed into law. That legislation transferred to the Secretary of the Treasury the authority and responsibility for overseeing all contracts signed by the Synthetic Fuels Corporation prior to its abolition.

Mr. Secretary, the question I would ask you today is what actions do you intend to take to void the October 16 Union Oil contract which we both agree was improperly entered into and therefore nonbinding? I might point out that it is the October 16 contract which is being used as the argument that there was a prior

commitment to sustain the new obligation that was entered into recently.

Mr. BAKER. Congressman, I have only been in office 2 days as Chairman of the Synthetic Fuels Corporation. I haven't taken any action yet, except to ask our lawyers to look at it.

Mr. WOLPE. I have confidence, Mr. Secretary, based upon your performance in so many other areas——

Mr. BAKER. I will tell you this; a lot of people disagreed with our conclusion when I was acting as Secretary of the Treasury, as opposed to Chairman of the Synthetic Fuels Corporation, that the contract was in fact not binding on the United States. There is a difference of opinion, as I understand it, among the lawyers, with respect to whether that is a condition precedent or that consultation is a condition precedent or whether it is something that is required but could be cured by the subsequent consultation that occurred.

Mr. WOLPE. I don't think there was any confusion in the minds of the Synthetic Fuels Corporation, in fact, it is precisely for that reason they kept making a variety of phone calls to Treasury, pleading desperately that the consultation take place in advance of the meeting date. Subsequently in the correspondence or during that period, in correspondence they acknowledged that the consultation had not taken place, and there was a continuing concern to the Corporation. There was no question in their mind. They are now trying to argue that——

Mr. BAKER. I think there was a question in their mind but they wanted to make certain there would not be a question with respect to the validity of the contract.

Mr. WOLPE. That's correct.

Mr. BAKER. I think the answer there is a legal question that has to be resolved by the lawyers. We are going to have the lawyers look at it.

Mr. WOLPE. In conclusion, Mr. Secretary, there is really no issue if the focus is upon the October 16 agreement as distinct from the more recent action that was taken. The October 16 agreement is being cited as the basis for the new obligation. The October 16 agreement, no reading of the history, I think, can lead to any——

Mr. BAKER. Did the board not meet subsequent to completion of consultation between the Synthetic Fuels Corporation and Treasury? I don't know. I am just asking.

Mr. WOLPE. Yes, for the purpose of making the more recent allegation, unless I misunderstand your question.

Mr. BAKER. The sequence of events was, we wrote them and told them they didn't consult; they acknowledged it. Subsequently, they consulted——

Mr. WOLPE. No; only after they signed the October 16 contract.

Mr. BAKER. After they signed the contract, they subsequently consulted, but didn't the board go back and ratify?

Mr. WOLPE. Then the form of the constitution to which we referred was the Treasury saying that it did not meet the standard of the law, that there would not be more than a minimum impact on capital markets. You had a negative finding in the postcontract consultation, which consultation clearly should have taken place——

Mr. BAKER. Well, clearly, Congressman, with this responsibility having been placed on me by the legislation, I've clearly got to take a position, and we will do so in line with the recommendations of our lawyers, once they've had an opportunity to review it.

Mr. WOLPE. Thank you very much.

The CHAIRMAN. The gentlewoman from California, Mrs. Boxer, is recognized.

Mrs. BOXER. Thank you, Mr. Chairman.

Mr. Secretary, again let me add my voice of welcome to you.

I am still a little bit surprised at your answer, Mr. Secretary.

Mr. BAKER. Yes, Congresswoman?

Mrs. BOXER. I'm still a little bit surprised at your answer to Mr. Russo when he talked about the effects of a $200 billion deficit on the economy.

Now as an old economics major—and I agree, I stress "old" because it's been awhile—has economic theory changed so much that $200 billion deficit isn't really considered priming the pump? Or put another way, if this Congress and the administration were to agree to end that deficit, not by 1991, but, let's say, by 30 days from today, would that have a negative impact on the economy?

Mr. BAKER. Well, I suppose it would depend on how you ended it. If you ended it through a tax increase, it would have a negative impact on the economy. If you ended it by taking $200 billion out of defense spending, I suppose it would have a negative impact on the economy. If you ended it by reducing—and I'm not suggesting this be done; these are all purely for the purpose of answering your question—let's say you ended it by reducing food stamps or whatever it might be, some entitlement payment——

Mrs. BOXER. But, Mr. Secretary, $200 billion, you couldn't end it by cutting the Food Stamp Program.

Mr. BAKER. No, you couldn't. But let's say entitlement payments.

Mrs. BOXER. You couldn't do it with that either.

Mr. BAKER. You'd have less of an impact—well, you couldn't; that's correct—entirely, but if that were the primary way that you did it.

All I meant in my answer to Congressman Russo is, I'm not a Keynesian economist. I don't necessarily agree with the view that every dollar you spend pumps up the economy by a dollar.

Mrs. BOXER. So, if I understand your answer, if you did end it very quickly, there are some scenarios where you feel you wouldn't really impact the economy, and that is if you just did it—if you could do it in food stamps, all in food stamps.

Mr. BAKER. Oh, well, that's purely hypothetical. The fact of the matter is, there would be some impact on the economy, but I don't accept the argument that it would be dollar for dollar, as a Keynesian economist might argue.

Mrs. BOXER. OK. Let me move on to Gramm-Rudman. Today, we've learned that CBO estimates that the automatic defense cut would be $49 billion if Gramm-Rudman were to go into effect in 1987. Now the President signed Gramm-Rudman, did he not? The President supported Gramm-Rudman, did he not?

Mr. BAKER. Right.

Mrs. BOXER. I would have to assume that if the President supports Gramm-Rudman, and he did, and he signed the bill, that he

took a look at what Gramm-Rudman would do to his military buildup and to the economy and to the budget.

And therefore my question to you is, Since I assume the President thought this all out, he assumes that's an acceptable ending, because we know in this Congress, we're trying to work with the President in the last 5 years—it has been difficult on both sides; I think the President and the Congress have both had a hard time working together. I think, frankly, that's why Gramm-Rudman passed, out of frustration that we might not be able to get at these deficits.

I'm assuming, then, that the President considers this would be an acceptable thing, to have this $49 billion cut, since it was very clearly a possibility. Therefore, if this committee were to take the budget and come up with something that maybe was a little less radical than Gramm-Rudman on the military—say, a freeze—that the President might consider supporting that as an alternative to Gramm-Rudman. What do you think about that?

Mr. BAKER. I think it's out of the question—it's off the wall; there's no way he would.

Mrs. BOXER. So it's off the wall? He would prefer Gramm-Rudman to a freeze on military spending? He would prefer a $49 billion cut than a freeze?

Mr. BAKER. No, that's not the point—he would prefer that the Congress enact his budget.

Mrs. BOXER. Well, we know that.

Mr. BAKER. Well, that's his preference.

Mrs. BOXER. The Congress hasn't done that in awhile, and I don't think the Congress is going to do it this year.

Mr. BAKER. In addition, we also know that very soon the Supreme Court is going to consider the constitutionality of an aspect of the sequestration provision, so for this reason also, it's entirely possible that the scenario you paint won't ever occur.

Mrs. BOXER. So, in other words, you're hoping maybe that Gramm-Rudman is booted out, and then the President won't have to deal with it?

Mr. BAKER. No; the point is not whether an aspect of Gramm-Rudman is booted out, the point is that Gramm-Rudman mandates certain deficit reduction levels, which is very, very healthy.

Mrs. BOXER. Right.

Mr. BAKER. And we expect that this feature will give us the political will and discipline necessary to deal with the problem. Thus we need not necessarily rely on sequestration—you know, the Justice Department, the President's Justice Department, was the one that challenged the constitutionality of that particular provision that relates to sequestration.

All I'm saying is, I don't think the doomsday scenario with respect to defense that you paint is necessarily going to occur.

Mrs. BOXER. Well, Mr. Secretary, it's not doomsday. It's Gramm-Rudman.

Now let me just ask you one question with a yes or no. Do you consider military spending Federal spending?

Mr. BAKER. Yes.

Mrs. BOXER. Then I would ask you to relook at your conclusion where you say that your big aim is to control Federal spending, be-

cause you're not doing that. You're continuing this massive buildup in the military shown here in the pink, and you are just shifting spending.

Mr. BAKER. We are asking for a 3-percent increase in real terms over what we agreed to with you as recently as last August in the 1986 congressional budget resolution, and at that time we agreed to reduce from the President's defense spending request by $290 billion over 5 years.

Mrs. BOXER. Well, we disagree on the baselines, as you know, and the press doesn't seem to agree with you either. They talk about an 8 percent real growth. Thank you.

The CHAIRMAN. The Chair recognizes the gentlewoman from Illinois, Mrs. Martin.

Mrs. MARTIN. We're now going to have press baselines, in addition to CBO and OMB. That will be entertaining for awhile.

Mr. Secretary, let me just add to the gentlelady from California, maybe the President believes the Congress will actually act before sequestration, which is, I know, the hope of the chairman of this committee and the acting ranking minority member—that we look for the reality, not from the far end of either party, but looking for that ground where we can all share.

Mr. Secretary, I'd like to follow up the gentleman from Colorado's questions on the Internal Revenue Service, just with some comments, and I know you're still relatively new.

I would just tell you, in my area, the Internal Revenue Service has removed its phone number from the phone book, which makes it very difficult to serve the people, because the only folks that know how to get ahold of them have to drive to get there.

Second, in the President's budget, quite understandably, there is not going to be charges for opinions. I understand that. But I would hope that the Internal Revenue Service, that some of their—not necessarily their agents, but within their offices, could also remember they are civil servants and be both.

The number of complaints, I must say, has risen dramatically, to my office, not just from attorneys, but from human beings who were truly not trying to avoid taxes. I mean, they were not talking about some strange offshoot group saying, the Internal Revenue Service is unconstitutional, but normal human beings.

I would hope you would check overall to make sure phone numbers are listed, because it seems to me that's a minimum, that Government offices have to remember who is paying the salary, and it's the folks out there.

Mr. BAKER. I would agree with that, and I will.

Mrs. MARTIN. Thank you.

The CHAIRMAN. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman. Mr. Secretary, it's nice to see you on.

On handling this budget problem, I've been very interested in the problems of high income, relatively high income retired people receiving entitlements, regardless of what their income was. And, of course, when we say "entitlements," we're really talking about—Social Security and Medicare are the big ones. After we get past Social Security and Medicare dollarwise, we start running short on money.

And as we've looked on what to do about that, such as COLA freezes like were proposed last year and so on, every study has always shown that there wasn't any way to do a COLA freeze and not hit approximately a third of the people on Social Security whose total income is below $10,000. And that s a guess because it's hard to get exact with those numbers.

So, I've thought we should expand the taxation of benefits on Social Security. As you may know, there have been studies on that showing, for instance, the amount of the benefit received that in no way was a result of the Social Security tax that people paid in when they were paying in Social Security taxes.

And I hope I'm not asking a question that if I get a no to, I'm going to wish I hadn't asked it, and thereby we're out of the ball game again on trying to find out what to do about getting this budget under control, because we must look at the military and Social Security to get this thing under control.

Do you think it would be possible for us to pass—thereby the administration would need to accept it—a plan along the line that the Speaker of the House mentioned last year that came out of a 1979 study? The study was done, I think, for the House Democratic Caucus at that time. The study talked about taxing Social Security benefits on a more equitable basis, that went along the line of maybe that 80 percent of the benefit ought to be taxed for people whose incomes are over the existing threshold. Or I would also be interested in looking at a different threshold on doing that. Would that type of a plan have a chance of making it past the administration?

Mr. BAKER. When the Speaker made that suggestion, Congressman, the President said, "If the Speaker is suggesting that, we'd obviously have to take a look at it," and the Speaker promptly withdrew it, if you go back and look at the record.

Mr. LOWRY. Well, I'm really not as interested in the history. It's just finding a solution to this problem.

Mr. BAKER. No, I understand. I understand. But you are aware also of the political volatility of the issue, and you are aware, I'm sure, that in the Social Security compromise of 1983 to fix the system, we went to a system, whether you call it benefit reduction or a tax on benefits. We went to that system, but we went to it only in the context of an overall agreement involving, if I may say so, the leadership of both of our major political parties, because there is no other way to deal with that issue, in my view.

And I worked on that, along with representatives from the Speaker's office and others from the administration, and as I recall it, we ended up with a proposal that became law that, in effect, subjects to taxation one-half of the benefits of married couples filing jointly with income—including Social Security benefits—in excess of $32,000 and similarly, one-half of the benefits of individuals with income in excess of $25,000.

But if such a proposal is to be advanced now as a means of dealing with the deficit or for any other reason, it's my view—and I'm speaking only for myself personally—that that should come from the leadership of your party.

Mr. LOWRY. That's fine with me. I hope the leadership of my party and of the other party will step forward and do this, because

we can talk about getting this thing under control forever. If we don't have the two elements, the military and Social Security in it, we are all kidding ourselves.

And then if you get into how is the equitable way to do it, we move to this. And I appreciate your answer. I think I understood your answer. Thank you.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

Mr. Secretary, there is a great deal of uncertainty across the country, and my part of the country especially, about the effective dates of the tax reform package, and there have been resolutions passed by the House and I think one even passed by the Senate, expressing the intent of both Houses that the effective date should, in fact, be January 1, 1987, at the earliest; is that not correct?

Mr. BAKER. No, no; that was not the sense of the House resolution, Congressman Slattery, but it may have been in the Senate. There was a resolution passed by the House suggesting that the problem be dealt with, but not fixing a date.

Mr. SLATTERY. All right. What I would suggest, Mr. Secretary, is, I think you're correct in terms of what the Senate resolution stated, and you're also correct with respect to the House resolution just saying that everybody is going to get together and talk about it. But I don't think anyone in the Congress wants an effective date of January 1, 1986. In other words, they don't want a retroactive effective date of this particular act.

What I'm asking you to do, Mr. Secretary, is ask the President to make it clear that he will not sign into law a bill that has an effective date that is retroactive; in other words, make it clear that it's going to be an act with prospective application. And I think that he could do the country a great service by saying that, because it is clearly the intent of those major players in this effort that it not be retroactive. And there is still a great deal of uncertainty out there in the land as to when it will be effective.

Would you ask the President to make it clear to the world that he will not sign a tax bill that has a retroactive effective date?

Mr. BAKER. Well, that creates some problems, Congressman, in terms of the Senate's dealing with tax reform, to be very honest with you.

A better way to approach it is the way that the Senate and the House have suggested and which we stand ready to do, and that is—and it's the same way we approached it, if I may say so, in 1985—and that is for us to sit down, for Treasury to sit down with the ranking member and the chairman of Ways and Means, the ranking member and the chairman of Senate Finance, and agree on certain guidelines with respect to effective dates, depending on what provisions we're talking about—reduction of rates, elimination of deductions, others.

Mr. SLATTERY. OK. Maybe that would be helpful.

Mr. BAKER. You cannot unequivocally state "no retroactivity," or you will severely hamper and limit the ability of the Senate, in my opinion, to deal with tax reform.

Mr. SLATTERY. The one area that has been most, I think, sensitive here is the whole question of bonds.

Mr. BAKER. Bonds; that's correct.

Mr. SLATTERY. And that's one area that perhaps the President could limit his statement to the question of bonding authority, and those provisions would not be retroactive.

I need to move along, because we have this bloody 5-minute rule, you know.

Mr. Secretary, in response to a question asked by Mr. Fazio with regard to the effect of the enormous change in our position as a debtor country, you responded by saying that you were not terribly alarmed by this, simply because of the fact that we were investing the money that we were supposedly borrowing from around the world.

Mr. Secretary, are you aware of the net fixed investment rate in this country—that is probably the most accurate measurement of investment in the country—over the last 30 or 40 years?

Mr. BAKER. Over the last 30 or 40 years; no, sir.

Mr. SLATTERY. Are you aware that between like 1951 and 1980 that the rate ranged between 6.9 percent and 6.7 percent? Probably not. I don't expect you to.

Mr. BAKER. No; there are various ways to calculate that rate but I'll accept your numbers for this discussion.

Mr. SLATTERY. In fact, since that time, contrary to your response to Mr. Fazio, the net fixed investment rate in this country has significantly declined, which would lead us to believe that, in fact, we are not, as you would assert, investing the money that we're borrowing from around the world. The rate has dropped—the 5-year average from 1981 to 1985 is now still below 5 percent, and it is significantly lower than the 6.7 percent to 7 percent rate of the previous 30 years. If you just average it all out, it runs about—so there's been a drop in the actual investment rate of somewhere in the neighborhood of 20, 25 percent at a time when we have been sucking in capital from all over the world. So I just wanted to clarify that point that you made earlier.

Mr. BAKER. Well, may I respond to that, Congressman?

Mr. SLATTERY. Sure.

Mr. BAKER. I think it's fair to say that we have seen an investment boom over the last 3 years. That's what I'm talking about. The overall investment rate would, of course, include investment of domestically generated funds as well, and it may be that the overall investment rate is not as high as it was 10, 15, 20 years. But I don't think it follows necessarily that we are using these funds that come from abroad for purposes other than investment or that they're not producing a part of this economic recovery that we're enjoying.

Mr. SLATTERY. OK; I don't dispute that point. But I would also argue that what we're doing in this country is sucking in over $100 billion last year, and we consumed a lot of that money, too, and I think it's a little bit misleading to say that we invested all of that money. A lot of that money was consumed also, and I think it goes into the whole, total economy, and it's disbursed as other dollars are also, or actually utilizes other dollars.

The last point that I want to make in the remaining time that I have, Mr. Secretary, is the whole question of our absolute inability, it seems like, in the last few years to even come close to paying our bills in this town. And one of the great myths, I think, that persist

is the fact that spending over the last 20 years has dramatically increased as a percentage of gross national product.

And if you do, as the President has suggested, and that is to remove Social Security and the payroll taxes that fund Social Security and Medicare and take it off the budget, as the President has suggested—and by the way, I disagree with him on that point, but that's what he has suggested—and if you go back to the early 1960's, prior to the Great Society, you can see that we were spending, as a society, about 16.5 percent of gross national product. That has increased to 17.4 percent today when you remove Social Security from the table and Medicare.

In the early 1960's, we were taxing the American public to the tune of 16 percent of gross national product to pay for that spending of 16.5 percent. Today, the revenues generated to fund that 17.4 percent of spending have dropped from 16 percent of gross national product to 12.5 percent of gross national product.

Mr. BAKER. You're talking about non-Social Security spending now?

Mr. SLATTERY. That's correct. But the President says, "Take it off the table," so I'm just saying, if you do take it off the table, that's the reality that you're looking at. You're looking at a 5-percent spread in the balance.

So what we tend to do with this Social Security debate is leave it on the table for counting the revenues, take it off the table for counting the expenditures, which is an absolute absurdity.

And I guess the point that I would make to you is that when you consult in your highest levels of power in this town, that you might make this point, that when you do as the President is suggesting, you create an enormous imbalance that argues quite, I would say—if you were in a court of law, you'd say there is prima facie evidence that we are not paying our bills; we're asking our kids and grandkids to do it.

And we ought to address it. We ought to face up to it. If this was the county commission or the state legislature, or if we had a constitutional amendment requiring a balanced budget, the democracy would make decisions with respect to spending, and the democracy should also make decision with respect to paying for it. And, of course, we've broken down the mythology in this town in the last few years. Now the myth is, we don't have to pay for it. And now the myth is, if you tax more, you'll spend more, which—I mean, I'm trying to think how that mythology would work in Austin or in Topeka or any other place in the country, and it just wouldn't work.

Mr. BAKER. I have a little—some of the things that you say, I don't disagree with, such as the importance of dealing with the problem—but I have a little difficulty understanding your assertion that we leave it on the table for one purpose and take it off for another.

Mr. SLATTERY. Well, that's the game we're playing.

Mr. BAKER. Well, we're leaving it on the table for both purposes, as is shown in the chart that's attached to my testimony.

Mr. SLATTERY. But the President is suggesting that the deficit is not affected by Social Security. He has said publicly that we should

take it off the table, and we should take it out of the budget, for goodness sakes.

And I'm saying if you do what he has suggested, then the numbers that I have just presented to you reflect the reality that you're dealing with.

Mr. BAKER. I understand. But he's never suggested that you shouldn't look at it as a tax or a charge on the economy. He's never suggested that.

Mr. SLATTERY. He has said it doesn't have anything to do with the deficit.

Mr. BAKER. I understand. He says it's a trust fund.

Mr. SLATTERY. He's wrong, but he has said that, OK.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas, Mr. Boulter.

Mr. BOULTER. Mr. Secretary, I'm sorry I've had to miss some of your testimony, and I would not want to miss this opportunity to say how proud I am of your service and what a good job I think you're doing.

I want to ask you a question that I doubt has been touched upon in the committee hearing this morning. As you know, I represent a farm producing district in Texas, and Mr. Slattery represents a similar area in Kansas, and I want to ask you something that I think concerns all of us and that I'm very much aware of.

We have a policy in our country of funneling large amounts of taxpayer dollars through international financing institutions to help lesser developed countries, like Venezuela, China, Yugoslavia, and Argentina, and much of this money is either expressly designated for subsidizing agricultural production, or whether it's designated for that purpose, it gets used for that purpose. This practice seems unfair to me. For example—I think we not long ago made something like an $80 million loan to China that was used to subsidize their cotton production through the World Bank, and they've had a tremendous increase in their cotton yields, and other countries are doing the same thing with U.S. taxpayer money that gets funneled through these institutions, I suppose for the purpose of allowing these countries to export and have some cash and make some interest payments with the large banks that make loans to them. I can see why that would be a problem.

But what it's doing is increasing the world surplus of these commodities. It's keeping our own farm prices low. It's actually making it more difficult for our farmers to regain their share of the world market in restorable commodities. It just seems unfair to me that we're doing that at a time when this segment of our economy is so depressed and that we're actually using taxpayer money to do it. Do you see any inequity in that policy? Could I and some of us get you to look at that?

Mr. BAKER. We've looked at it, as I indicated earlier, Congressman Boulter, with respect to loans, for instance, concerning copper production.

Mr. BOULTER. And you've got the same problem there.

Mr. BAKER. Obviously we've looked and we voted against a number of those loans. We voted against agricultural loans, and particularly where they are loans to state entities, parastatals.

Mr. BOULTER. But the money gets used anyway.

Mr. BAKER. Well, it can be used over our——

Mr. BOULTER. Over your objection.

Mr. BAKER [CONTINUING]. Over our negative vote. But that's a consequence of belonging to a multilateral institution, and I don't think you would suggest for one minute that we ought not to belong to an institution that is so vital to the continued existence of some of the fragile, new democracies around the world, and particularly those south of us, as I testified earlier.

Mr. BOULTER. No, sir.

Mr. BAKER. But surely we would take a look at that. But I might also say, Congressman, that some of those countries, some of the agricultural loans that have been made have been made against commitments from those countries to reform their economy, their agricultural sector economy, toward a free market, growth-oriented type system.

That's not something we, particularly those on our side of the aisle, would object to. And the funds that they generate from exporting those products are oftentimes used to buy American products, sometimes much of it being agricultural products.

So you have that terrible difficulty in resolving what is a very valid concern that you have against that other, I think, equally valid concern.

Mr. BOULTER. Of course, we need to belong to those institutions, or at least I guess we do. I might think about that some more, but I'm sure you're right. But when we do vote no, when we do object, and our money is used anyway because of the other directors and we get outvoted, I have introduced legislation that would curb our future contributions to the extent that the money was used to subsidize those commodities, and I would hope that you'd be open to that and look at it with me, and I'd like to talk to members of your staff about it sometime. Where we object and our money is used for the purpose anyway, then we can do something about it when it comes time to make future contributions.

Mr. BAKER. Well, ship it down and let us look at it.

The CHAIRMAN. The gentleman from New York, Mr. Schumer, is recognized.

Mr. SCHUMER. Thank you very much, Mr. Chairman. I apologize to Secretary Baker for coming in at the tail end of his testimony. It's either feast or famine in terms of hearings, and today Chairman Volcker was testifying before the Banking Committee. So in my opinion, we had two of the smartest, most capable people in Washington at either end of the House Office Buildings.

Let me ask a couple of questions. My first question draws on your wisdom as former Chief of Staff in the White House as well as Treasury Secretary. There is a great deal of concern on the House side and the Senate side that the actual projections and baselines in the President's budget are overly optimistic in a variety of ways. And as you well remember, last year we here voiced a similar concern, but Senator Domenici and others agreed to go along with the President's baseline.

Assume that this year Chairman Gray and Chairman Domenici got together and said, Let us have a summit conference so we can resolve this baseline issue. With Gramm-Rudman, it is far more important that we use the right numbers this year. Would you recom-

mend that the President or his surrogates participate in this kind of conference?

Mr. BAKER. I really wouldn't, Congressman, and the reason I wouldn't is that this year you've got no daylight between OMB and your own Budget Office.

Mr. SCHUMER. There is plenty of daylight. I disagree with your statement. I think there is quite a bit of difference between the two—for instance, regarding defense spending projections.

Mr. BAKER. Well, you have about $14 billion on defense outlays for fiscal year 1987, which I don't think, in the big picture particularly since the executive branch can control the rate of outlays given the budget authority for defense, and when growth forecasts are roughly equivalent, and when estimates of total outlays and deficits are within a few billion dollars, there's really no daylight. So what are you going to get together and resolve?

Mr. SCHUMER. When you have to cut $40 or $50 billion from the budget, and when the percentage of defense cuts and nondefense cuts has been a bone of contention in both Houses, $10 billion is hardly a trivial number. Agreement on this is probably essential if we are to arrive at a budget that avoids the thing that everybody says they want to avoid--which is, of course, Gramm-Rudman cuts.

Mr. BAKER. We're really not talking about $40 or $50 billion to start with. We're talking, as I indicated in earlier testimony, that we're really talking about $23 billion in domestic spending cuts.

Let's agree that were talking about $38 billion overall, which is what CBO says we're talking about and what OMB says. We've submitted a budget that has $6.3 billion in revenue increases in it. It's got $2.7 billion in defense cuts in it.

Mr. SCHUMER. That is a number over which we disagree.

Mr. BAKER. OK. It's got $3 billion in sales of assets in it, and $3.6 billion in other offsetting collections and net interest. Take these out and you take the $38 billion down to $23 billion, and that's what the President is asking you to take out of domestic spending programs, domestic spending programs which we are now spending $418 billion a year on. The President is asking you to cut a nickel, one nickel out of the domestic spending program budget.

And we don't need to quibble—I mean, even if there's a disagreement with respect to the defense outlay number, if you split the difference, you're not talking about much in terms of the big picture.

Mr. SCHUMER. Well, I have been on the Budget Committee for only 1 year, but I would say the greatest bone of contention among the three parties—House, Senate, and President—is the ratio of defense cuts to nondefense cuts.

You say that $23 billion is 5 percent. But look at it from the viewpoint of the urban programs. To reach that $23 billion in cuts, you have 50 or 60 percent cut if not total elimination of the three or four most important urban programs.

The only way I can even come close to selling that to my constituents is if they feel that defense is taking a share. I cannot do that if I assume the President's numbers. We assumed the President's numbers last year. We, in the House did not want to make this assumption. But we agreed to. And then because we agreed to

assume that Rose Garden baseline, our $50 billion in reductions totally vanished.

Mr. BAKER. In August of last year, as recently as August of last year, you had one of these big, grand agreements that you're suggesting that we have now. Well, we agreed—the executive and legislative branches agreed on the fiscal year 1986 congressional budget resolution level; right, Mr. Chairman? That is right, isn't it?

The CHAIRMAN. Mr. Secretary, I would just simply say——

Mr. BAKER. Well, OK, let me state it as a fact.

The CHAIRMAN. I would just simply say that I never got a call from the President that——

Mr. BAKER. I saw you frowning. But there was—OK.

The CHAIRMAN [continuing]. And I don't remember the President ever endorsing our budget resolution.

Mr. BAKER. Well, there was a congressional budget resolution that was certainly entered into after a lot of discussion over here in the other House between the executive branch and the legislative branch.

The CHAIRMAN. That I do remember.

Mr. BAKER. That you do remember. And there was an adoption by the President of a top line for defense that was $290 billion less than what he wanted over a 5-year period. So to suggest that somehow there has not been—that the President has not been forthcoming on defense, I think really doesn't square with the facts.

Mr. SCHUMER. I could say that domestic programs are $200 billion less than what I want or what the House Democrats would want.

But you do not talk about what somebody wants. A baseline should be agreed upon. Your statement that the President will not come to the table and talk about those numbers makes me doubt the sincerity about deficit reduction.

Mr. BAKER. Congressman, I think you do talk about what somebody wants, when it's the President of the United States and Commander in Chief and you're talking about the defense budget. I really think it's germane to talk about what he thinks is important to the national security of the United States.

In terms of coming to the table, the Constitution requires the President to submit a budget and requires the Congress to act on it. We are 1 week into the budget submission process. Before he even submitted his budget, we heard all the cries up here about how the President must exert some leadership, he must come to the table. At the time you had not yet received his budget; but you rejected it before you ever got it.

I don't think that's——

Mr. SCHUMER. Secretary Baker, there are lots of parts I disagree with, but we are in difficult times. I for one, am willing to come and sit and try and talk. I wish the President would do the same.

Mr. SLATTERY. Would the gentleman yield about 30 seconds?

Mr. SCHUMER. I do not have much time.

Mr. SLATTERY. One of the things that I think the Secretary ought to focus on for just a second is that we're really not talking about the nickel, so to speak, out of the $450 billion or $480 billion, whatever your figure was for the domestic budget that's left.

Just the simple arithmetic is that you have approximately a $300 billion Pentagon budget, close to that, $150 billion in interest payments, $400 billion added to that, Social Security, $200 billion which is taken off, so you've got $650 billion there, and then if you look at about another $100 billion of the budget that the President wants to actually increase or doesn't want to touch, you're narrowing it down very quickly to about $200 billion of the budget that's really on the chopping block.

Mr. SCHUMER. If the gentleman would yield, it is really $90 billion in domestic spending.

Mr. SLATTERY. And that's where we're coming from. So it's misleading to say that we're going to sort of look at $450 billion of the budget and only find 5 percent. The fact of the matter is, even under the President's budget, Mr. Baker, we are really narrowing it down to about $250 billion at the most from which to make the cuts.

Mr. BAKER. But, Congressman, I don't think it's fair to say that those domestic spending programs that the President would not like to see cut are off the table. The constitutional process mandates that they're on the table, because we propose and you dispose. And I think it's a fair statement to say that there's $418 billion in domestic programs after you take Social Security out, from which we're seeking $23 billion.

Mr. SLATTERY. You're suggesting that the Congress should take initiatives in perhaps other areas of the domestic budget that the President did not——

Mr. BAKER. No, I'm not suggesting that. What I'm saying is, in terms of looking at the universe, I think it's only fair to look at what the universe really is.

The CHAIRMAN. I would like to have a couple of comments before we conclude the hearing. I don't think we need to argue the point any more. I would tend to agree with some of my colleagues about the misleading rhetoric. It's not a nickel. It's a nickel after sequestration and after several billions of dollars of recisions and deferrals. Therefore, the nickel comes up. If you really look at it substantially more than that——

Mr. BAKER. You mean after 1986 sequestration?

The CHAIRMAN. Yes.

Mr. BAKER. I agree with that.

The CHAIRMAN. Because in your baseline, not only sequestration, which we haven't acted upon, by the way, but it is going to happen March 1. Also, Mr. Secretary, you have got billions of dollars' worth of recisions and deferrals, which are quite questionable, built into that.

Mr. BAKER. We have $1.5 billion in outlay savings from fiscal year 1986 rescissions.

The CHAIRMAN. Therefore, if you add that, it is really about a 10-percent cut off of a narrow piece rather than the applied 5 cents.

Let me just say this; I don't want to get into it, because I think I have already done it with Mr. Miller, who has that primary responsibility. Knowing your influence, you have input into it. The debate about baseline and underestimation is extremely important.

Senator Domenici today on "Good Morning America" volunteered that the President's budget was at least $15 billion out of line because of underestimates in outlays.

I would agree with you that the other economic assumptions, et cetera, are close. The difference, Mr. Secretary, that I want to point out to you, is if you miss it on the outlays, when that snapshot is taken in August, that old rubberband is going to pop right back and hit us. It may not hit you. It may not hit the White House. The President is very good at saying, hey, it is Congress' responsibility.

Thus, the $23 billion domestic cuts, which you point out correctly, after you remove privatizations and your revenues goes from $23 billion to $38 billion. These, you stated were revenue increases instead of user fees. That's a major difference. That is what concerns many of us, if we have some mistakes in there, let's straighten them out, particularly since the President claimed so eloquently that he met Gramm-Rudman $144 billion, which is required of him under the law as well as us. There are many of us, including CBO, most of the private econometric associations, as well as Senator Domenici and the Senate Budget Committee, that don't think he made the $144 billion. That's a major item, which in the past year, we didn't have to pay attention to, but this year because of Gramm-Rudman we have to.

One last thing; I am not asking for a comment on this. I think you have commented. You say that large foreign borrowing is not a problem, if we use the borrowed capital productively. This implies that investment has risen to reflect the foreign borrowing. There are some problems with this. One, we are borrowing more than $100 billion per year. Two, gross investment is running only about three-quarters of 1 percent of GNP, higher than in the 1970's. Three, as Mr. Slattery pointed out, net investment is lower than in the 1970's, 1960's, and 1950's. Productivity growth is lower than it has been historically. Last year, it was zero.

Yes, we are a debted nation. We were a debted nation in the 19th century. We were borrowing money from Europe and with the money we were investing in opening up the West, building canals, building railroads, building cities, building factories, going through the industrial revolution. That is not what we are doing right now. We are consuming it, both privately and publicly.

I really don't know how we can say that borrowing is being used productively when all the indicators are it is not being used productively, unless you are going to use Wall Street. I don't know too many Americans that have lots of shares there. Only if you look at the temporary growth of a 37-month period, which has been good. However, I don't see it as being productive investment that is going to sustain us as we were doing in the 19th century.

That is the concern I have. Maybe you would like to comment on it in a more written fashion. I will be glad to write you.

Mr. BAKER. I would be glad to do that. I do think as you suggested, I have responded to that in my comments to Congressman Slattery. I will be glad to submit a more definitive statement for the record.

The CHAIRMAN. I would like that. You have been here now for 2 hours and 45 minutes. As Mrs. Martin says, when you are having a good time, it goes quickly.

Mr. BAKER. Time goes by so quickly when you are having fun.

The CHAIRMAN. As usual, Mr. Secretary, you have been very informative and very straightforward with us. We will be submitting additional questions for the record, which we hope you will respond to promptly. We look forward to continuing to work with you as we try to deal with the problems that we face jointly.

Mr. BAKER. Thank you very much, Mr. Chairman.

The CHAIRMAN. We will recess until 2 p.m. when we will resume the hearing this afternoon.

AFTERNOON SESSION

The CHAIRMAN. The committee will now come to order. Good afternoon. The House Budget Committee is reconvening to continue our Washington hearings on the President's 1987 budget and the potential impact of the budget on the American economy.

Yesterday we heard from the Director of the Office of Management and Budget. This morning, Secretary of the Treasury, James Baker, appeared before the committee. This afternoon, we will hear from our first private sector witnesses during this series of Washington hearings on the 1987 budget.

I am pleased to welcome representatives of the major national organizations representing business and corporations, to address the committee this afternoon.

Appearing today are Robert Dee, chairman of the National Association of Manufacturers; Frank Morsani, chairman of the Chamber of Commerce of the United States; and Robert Kilpatrick, chairman of the Budget Task Force of the Business Roundtable.

We thank you gentlemen for taking the time to share with the House Budget Committee the views of your organizations.

The United States is now in the 39th month of economic expansion, well beyond the average length of post-World War II expansions. However, this expansion has been a very uneven one. It has been accompanied by risks and pitfalls which promise to make any future economic pause or decline longer than it need be.

Along with this expansion, we have experienced $200 billion deficits, which have contributed to high real interest rates and an overly strong dollar. Large amounts of foreign capital have been required to finance these Federal deficits as well as investment during this expansion.

Many enterprises have prospered, but others, like some manufacturing firms and agricultural exporters, have been dealt severe blows by record trade deficits and foreign competition. Deflation has helped put farmers out of business and threatens many savings and loan institutions. Commercial banks are threatened by defaults from debtor developing nations and oil producers. Job growth during this expansion has been concentrated in one area, the service sector. Such an uneven expansion threatens its own continuation.

Two weeks ago today, President Reagan submitted his 1987 budget with the same priorities as in previous budgets. There were

continued real growth in military expenditures, drastic reductions in nondefense spending in order to finance the defense buildup, while staying within the Gramm-Rudman target, and an adamant refusal to consider any revenue increases.

Many of us in Congress are concerned that the 1987 budget only contributes to continued uncertainty about the path of the economy by failing to deal with the risks of continued high deficits in a fair and balanced manner.

We welcome the three of you who are here to represent the views of the private sector. We look forward to your testimony and seek your opinions on ways that we can deal with the deficit problem we face.

By the time the Budget Committee completes all of the Washington and field hearings, we will have heard from representatives of every major sector of our great Nation. We will have heard the views of State and local governments, small businesses, senior citizens, organizations serving children, rural America, and agricultural America, labor organizations, veterans, students, and the poor.

We welcome today the distinguished group of representatives coming from the business community. We believe they will share with us information as to how they believe we can address these critical problems and choices that face us.

Gentlemen, we welcome you today. We invite you to summarize your testimony. The testimony in its entirety will be submitted for the record. That will allow us to get into questions. Before we begin, I would like to call upon the acting ranking minority member, Congresswoman Lynn Martin from Illinois, while Mr. Latta, of Ohio, is recuperating from heart surgery. Congresswoman Martin.

Mrs. MARTIN. Which proves conclusively Republicans do have a heart, Mr. Chairman. [Laughter.]

Even though I certainly wouldn't wish upon any of us the need to prove it in such a manner. On behalf of the chairman and myself, we miss Mr. Latta desperately and await his return.

To all three of you gentlemen, I thank you. Because I will be leaving shortly, I took the opportunity and the time that was available to read your testimony. All three of your groups, for instance, called for deficit reduction by again, looking at entitlements, including Social Security, and I am sure you will comment on that in your testimony. Although I am going to say that you gentlemen probably would not be dependent only upon Social Security when you retire.

I would hope that within your testimony, or later for the record, that you might also include things that affect the business community directly and where to cut.

For instance, I find it very easy to cut new mass transit in Los Angeles. This is not a giant surprise since I am from Illinois. I am just suggesting in a quick perusal, that although there is some mention of defense spending, I would truly welcome specifics if you can give them. We will eventually settle the assumption arguments, as interesting as that may be in the paper.

In this incredibly short time period that this committee has, 2½ to 3 weeks to come up with something to bring to the floor, those

decisions will be actually made on a different plane. We could really use your help.

The NAM and the chamber especially, represent such a broad range of clientele, that to hear from you and to also have you in that leadership role, willing to cut some of those things that directly affect you, would be very impressive, indeed. I will say, having looked at your testimony, gentlemen, I am pleased to see you share the President's goal. Like us, you may differ somewhat in the priorities, but share the belief that deficit reduction must be accomplished and it will not come easily to this Congress and we must all work together.

We welcome you. We apologize.

The CHAIRMAN. Thank you very much, Congresswoman Martin. Let us begin. If we could, we will follow the order of Mr. Dee, Mr. Morsani, and then Mr. Kilpatrick. We urge you to summarize. We have your written statements. That will allow us to get into questioning, as I know at least two of you will have to leave fairly early.

Mr. Dee, why don't you begin?

Mr. DEE. Do you want me to use the mike or can you all hear me?

The CHAIRMAN. You have a good preacher's voice, but I think for the record you had better use the mike.

STATEMENT OF ROBERT F. DEE, CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF MANUFACTURERS, AND CHAIRMAN OF THE BOARD, SMITHKLINE BECKMAN CORP.

Mr. DEE. I thank you for that compliment, about the preacher's voice, but I can't take any credit, I'm afraid.

Mr. Chairman and members of the committee, my colleagues and I appreciate this opportunity to present our views on the Federal budget for fiscal year 1987 and what we believe should be done to achieve a balanced Federal budget and bring the burgeoning Federal deficit under control.

Before proceeding, Mr. Chairman, I would like to recognize and thank you for your skillful leadership in reaching meaningful compromises that have greatly strengthened the whole budget process. Your skill was especially notable in the last budget negotiations. I certainly have confidence it will be in evidence again this year. We are in your debt, sir.

Members of the organization we represent, the National Association of Manufacturers in my own case, but also the U.S. Chamber of Commerce and the Business Roundtable, who will speak later, all of us agree firmly that the Federal fiscal dilemma is the country's most urgent economic problem and has indeed reached the point of crisis. Its adverse economic effects are felt by everyone, by consumers, just as much as by manufacturers.

My prepared statement contains a more detailed analysis of the bitter economic consequences that flow from large and sustained Federal deficits. I will touch only on the highlights.

NAM and the American business community are absolutely convinced that the way to deal with the deficit problem, the only way,

is to control spending. That concept is fundamental and any other solution, in our view, is mere rationalization.

Control of the growth of Federal spending is admittedly difficult, difficult for legislators, difficult in many cases for the legislators' constituents to accept. We understand that. We recognize the conflicts and differences of opinion that Members of Congress do have to deal with.

We are convinced as well that increasing taxes to bring the Federal budget into balance is a flawed solution. The history of the American legislative process gives virtually no evidence that new revenues are ever used to reduce debt. The present reality, moreover, is there is no shortage of revenues. Federal revenues are running at approximately 19 percent of GNP, which is the average of the past three decades. Outlays, which averaged about 20 percent of GNP for three decades prior to 1980, have now climbed close to 25 percent of GNP, which is excessively high.

As the President has said more than once, the country has a spending problem, not a revenue problem. There is abundant evidence, unfortunately, that increased revenues only lead to increased spending, and that increased taxation does not assure a balanced budget in the long run. Higher taxes, especially on corporations, also tend to slow the economy. Tax increases on commerce, I feel, are self-defeating. Moneys that otherwise could go into the creation of new products and new jobs are taken into the Treasury. Even worse, it inhibits our ability to fight off foreign invaders who are entering our business scene. It inhibits our ability to deal with them on even terms.

Perhaps you are aware that just from 1979 to 1984, our country lost 4 million manufacturing jobs. Four million jobs disappeared overseas. It follows, therefore, that tax increases on consumers or corporations are a poor solution to the problem of deficit reduction.

Consequently, Mr. Chairman, we support the general thrust of the President and the budget he submitted to Congress earlier this year. His reliance on reductions and the growth of Federal spending as the major way to bring the budget into balance and to reduce the deficit is correct in our view.

I say this knowing full well, Mrs. Martin, that some of the largest cuts are in programs that support the interest of business generally, or are helpful to business in specific areas. For example, the President has proposed the elimination of the Economic Development Administration, urban development action grants, the Small Business Administration, the Appalachian Regional Commission, all of which have been a benefit to NAM members.

In addition, the administration's budget would eliminate or reduce other Federal programs that have an effect upon business and the economy in general. Examples are reductions in transportation programs and in programs aimed at helping the country's unemployed.

There is a problem with the President's budget. I say that having read in the press about some of the local reaction the committee heard last week when seeking opinions, at grassroots levels. That problem is not what the budget cuts but what it doesn't cut. Far too much of the budget is off limits. As a result, the severity of the proposed cuts is increased. It makes them politically unpalatable. It

makes them in many respects offensive both to legislators and their constituents.

In our view, there is no reason why the military budget should be exempt from restraint and the beneficiary of a significant after inflation increase. As Business Week pointed out in its current issue, and several other reports have confirmed, the President is insisting that the 1987 military appropriations should grow by 3 percent after adjusting for inflation. The budget computes that growth rate from the level agreed to in last year's congressional budget resolution, not from the substantially lower amount actually appropriated. That means the President's budget proposes to increase defense by 11.5 percent or about 8 percent after inflation.

Last year we supported a freeze in defense budget increases as part of an overall deficit reduction package. As studies have shown, we continue to believe that major economies can be realized in defense without jeopardizing the national security.

Mr. Chairman, we also believe that entitlements must be dealt with forthrightly in the budget review process. As the members of this committee know, there are different methods of defining entitlements, and even the House and Senate use different methods.

In one accounting I have seen from the Congressional Research Service of the Library of Congress, the actual figure, when everything is totaled for all Federal departments and funds, is near $500 billion. Only 15 percent of entitlements are means tested by relating payments to financial circumstances of recipients. Many have automatic cost-of-living adjustments. It is not rational Government to excuse them from the careful scrutiny to which every other Federal program must be subjected.

Although the President in his State of the Union Address called for a review of all welfare programs by the White House Domestic Council, the programs included make up only a fraction of total entitlements. The proper way to cut the growth of spending by any reasonable standard, is to provide for an indepth review of the cost effectiveness and the need for all entitlement programs across the board and without exception.

What is the best way to go about solving this problem? I favor a Presidential bipartisan commission composed of Members of both Houses of Congress and representatives of the public at large.

During a visit on January 24 with the President and his staff to hear the administration's budget proposals, I took the occasion to urge such a commission review the entire entitlement situation. That proposal has the support of the NAM, the whole business community, the Chamber of Commerce, the Business Roundtable.

The President's budget also provides for a degree of privatization through the sale of certain Government assets. We favor such sales in general because we believe there are Federal programs that can be more effectively carried out by the private sector.

We want to emphasize the obvious fact, however, that selling assets is only a one-time gain for Government. It does not provide a recurring revenue benefit. It must not be viewed as an alternative to reduced Federal spending.

Finally, I would like to state our views about the underlying economic assumptions of the Federal budget process. We believe that

process would best be served by basing it on realistic, sound, perhaps even less than optimistic economic estimates.

Again and again in the past, overly optimistic economic projections have been used to justify insufficient reductions early in the budget process. You know what the track record has been. I have been personally appalled at the inaccuracy of the forecasts. The average error of the OMB for the past 10 years has been 254 percent, and CBO's yearly deficit projections from 1979 to 1983 on average erred over 100 percent.

The NAM recommends, therefore, that the committee use economic forecasts that are closer to the real state of affairs in our economy than those in the President's budget, although doing so will force Congress to make additional reductions to reach the $144 billion maximum deficit target. It will mean that a real deficit reduction will actually occur and that the deficit target will be reached for fiscal year 1987.

If economic performance proves to be better than projected and the target is exceeded, so much the better for the American economy and for all of the American people.

So, Mr. Chairman, let me conclude by saying that the economic problem facing this great country brings us perilously close to a deep chasm of disaster. The action required calls for discipline and sacrifice on the part of all of us. The hour is late. The task has never been more demanding.

Thank you, Mr. Chairman.

[Testimony resumes on p. 278.]

[The prepared statement of Mr. Dee follows:]

STATEMENT OF ROBERT F. DEE

CHAIRMAN OF THE BOARD

NATIONAL ASSOCIATION OF MANUFACTURERS

AND

CHAIRMAN OF THE BOARD

SMITHKLINE BECKMAN CORPORATION

ON

THE FISCAL YEAR 1987 BUDGET OF THE UNITED STATES

BEFORE

THE HOUSE COMMITTEE ON THE BUDGET

FEBRUARY 19, 1986

I am Robert F. Dee, Chairman of the Board of the SmithKline Beckman Corporation. I am appearing here today, however, as Chairman of the Board of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on President Reagan's proposed FY 1987 budget.

1. Introduction

Since 1983, the U.S. economy has experienced fiscal deficits that are unprecedented by postwar standards, and unless the course of fiscal policy is substantially altered, there is a great risk that deficits of this magnitude will continue through the end of the decade. After peaking at 7% of GNP in FY 1983, the aggregate Federal deficit including off-budget categories has averaged over 5% of GNP, and CBO projections show the deficit fluctuating in the area of 4% of GNP during the remainder of the 1980s. While the initial rise in the deficit was due in part to the 1981-82 recession, the deficits projected for the late 1980s are distinctive in that they are structural rather than cyclical in origin. Expressed another way, the full-employment budget will exhibit structural deficits over the business cycle, a reversal of prior historical experience in which large deficits have typically been cyclical in origin.

In the absence of a substantial diminution of the fiscal deficit during the next few years, the longer-term deficits projected for the late 1980s are likely to have a destabilizing impact on the business cycle, and for this reason will create substantial problems of fiscal-monetary coordination. The misalignment of monetary and fiscal policy will contribute to keeping both long-term and short-term interest rates high, through expectational and flow of funds channels. They will contribute to keeping the dollar exchange rate overvalued, primarily by encouraging reserve inflows. Finally, they create the potential for a return to a more destabilizing monetary policy, in the event that policy makers should decide to accommodate the deficit through reserve money creation. Although this is comparatively unlikely, the existence of this possibility has contributed to the emergence of high "expectations premia" on interest rates, thereby keeping long-term rates higher than they otherwise would be.

This statement consists of four additional sections. Section 2 presents a brief overview of the Reagan Administration's FY 1987 budget. Section 3 outlines some perspectives from macroeconomic theory on the likely consequences of large deficits, and presents a critical examination of the degree to which these are applicable in the contemporary policy context, with particular emphasis on the implications for manufacturing. Section 4 examines a number of possible alternatives for reducing the deficit. Section 5 sets forth our conclusions.

2. The Reagan Administration's Budget

Since this committee is already familiar with the details of the President's proposed budget, an extended discussion is omitted here. However, certain salient features should be noted.

First, the budget relies on somewhat unrealistic economic assumptions in order to meet its deficit reduction targets. In order for the projected deficit levels to be realized, the economy would have to expand by 3.5% in 1986 and 4% in 1987. These figures are simply not very likely. It is not outside the realm of possibility that the economy could expand by 3.5% in 1986, although this requires a modicum of optimism. The consensus forecast for 1986 reported by the National Association of Business Economists is 2.7%, and NAM's most recent forecast is somewhat lower, at 2.6%; the consensus of major econometric models as reported by Business Week shows growth in the range of 3.1%. All of these forecasts, however, antecede the spectacular fall in oil prices, which as of the time of this writing have lowered spot market prices to around $15 a barrel. Some econometric estimates place the increment in GNP growth resulting from the energy price decline in the range of 0.5 to 0.8 percentage points. For

this reason, there is at least some possibility of obtaining a 3.5% growth rate in 1986, notwithstanding downside risks associated with high levels of consumer debt.

It is not probable, however, that the economy will grow by 4% in 1987. During that period, the initial effects of the energy price decline will dissipate, while for other reasons the economy is expected to slow. Here, several factors are at stake, including potentially intractable consumer debt burdens, the negative effects of tax "reform" on business investment, and the contractionary effects of fiscal restraint itself. Given these factors, the most likely outcome is for a slowdown in 1987, and several econometric forecasters are currently predicting a recession in the latter part of that year.

Under the circumstances, the long-term projections for the deficit must be evaluated as substantially more pessimistic than what is contained in the administration's budget. The result is that substantially greater reductions in spending will be necessary in order to reduce the deficit to targeted levels. Further, a recession in 1987 could actually raise the deficit, and throw the budget off its projected target path.

A second salient feature of the budget is the lack of realism in reducing spending. While real domestic spending is reduced by substantial magnitudes, defense spending is raised in real terms by roughly 8%. This is neither economically nor politically realistic. For reasons noted above, the growth rate of the economy will not be adequate to support military outlays of this magnitude. Moreover, at a time when other sectors of the budget are having major sacrifices imposed on them, massive increases in defense spending seem politically unachievable. Indeed, the Administration's obdurate refusal to make any cuts on the defense side provides ready ammunition to forces that would like

to thwart cuts in non-defense domestic categories. It also raises the likelihood of confrontation and stalemate between the Administration and the Congress over the entire budget, which would be far from productive from the point of view of reaching the deficit reduction targets. In our view a more productive--and also a more equitable--approach would be to spread the difficult sacrifices entailed in the deficit reduction process across all areas of the Federal budget, including defense. Furthermore, we would suggest inclusion of Social Security and all other entitlement programs in this process, despite the political sensitivity of doing so in an election year.

3. The Macroeconomic Implications of Structural Deficits

3.1 Perspectives From Economic Theory

Reduced to essentials, the current fiscal situation is one of large structural budget deficits which have been financed primarily through bond issuances and reserve inflows, i.e., by borrowing from the private sector and from foreign capital markets. The prediction of contemporary theory for the effect of bond-financed deficits on the economy is for an asymmetric impact on the business cycle. In the short-term, a bond-financed deficit yields an increase in economic activity through income-expenditure channels. Over a somewhat longer time horizon, however, greater pressure in capital markets resulting from higher government borrowing, coupled with higher private sector demand for credit caused by the pick-up in economic activity, will produce higher interest rates. Interest rates will also rise in the event that greater demand pressure throughout the economy causes an increase in inflation. Eventually, the rise in interest rates causes a slowdown in the economy.

Over the long term, if deficits are sufficiently large or prolonged, their effect may be quite adverse. A permanent increase in the deficit implies a corresponding permanent increase in interest rates. Once the temporary income-expenditure effects of the deficit are exhausted, the economy will diverge below its long-term potential growth rate. In this respect, permanent bond-financed deficits may actually be contractionary.

In recent years, several other channels through which deficits may be contractionary have been suggested. According to an argument proposed by the Rational Expectations theorists, large deficits may raise interest rates by raising inflation expectations. If financial decision makers anticipate that deficits may be monetized, they will exact higher risk premia on loans in an effort to mitigate the threat of devaluation of their real rates of return by inflation. Thus long-term interest rates which are heavily influenced by expectations may be raised above the levels implied solely by greater public sector participation in credit markets.

A second contractionary effect may emerge in the event that deficits are financed by foreign borrowing. In a fixed exchange rate regime, foreign borrowing will simply produce reserve inflows through the balance of payments and greater domestic liquidity. However, in a flexible exchange rate environment, foreign borrowing will be reflected in a real appreciation of the exchange rate and a loss in trade competitiveness. The loss in export opportunities coupled with greater import penetration will further depress real economic activity.

If the magnitude of these effects is sufficiently large, it is possible for a vicious cycle to develop. Large bond-financed deficits will slow the economy after an initial surge in activity through the high interest rate and loss of competitiveness mechanisms discussed above. Normally, the economy could be

expected to equilibrate itself inasmuch as slower growth would lower interest rates and reduce demand for imports, creating the preconditions for an eventual recovery. If, however, the growth slowdown is sufficient, the deficit will be widened due to inadequate growth in tax revenues. The larger public sector borrowing requirement will in turn keep interest rates high and the exchange rate overvalued, thereby depressing the growth rate. In this way, slow growth and large deficits will systematically reinforce each other in a circular and cumulative pattern. Expressed another way, a permanent structural deficit and the resulting permanently higher level of interest rates will keep the economy permanently below its potential growth path.

The foregoing suggests several possible outcomes resulting from large fiscal deficits: a destabilization of the business cycle characterized by violent fluctuations in real economic activity, high real interest rates, losses in competitiveness, and long-term stagnation. In order to evaluate the significance of large deficits, it may be useful to examine several such possibilities in somewhat greater detail.

3.2 Business Cycle Instability

The over-expansionary stance of fiscal policy appears to have had an adverse impact on the 1983-86 recovery. The recovery consisted of a five-quarter boom in 1983:2 through 1984:2, followed by a period of sluggish growth thereafter, with little indication of any likely return to faster economic expansion. During the five quarter period of rapid expansion, the growth rate of GNP averaged 7.8%. Since that time, however, GNP has expanded by an average of roughly 2%. The slight pickup in economic activitity in late 1985 was unspectacular, with growth rising only to the 3% range, and does not by any means signal an interruption of the slow growth pattern. Similarly, during the

period from March 1983 to July 1984, the index of industrial production rose by a cumulative total of 18.5%. However, from August 1984 to August 1985, the increase in industrial production was only 1%. During the same period, the capacity utilization rate in manufacturing fell from 81.8% to 80.2%, while capacity utilization in industrial materials dropped even more, from 83.1% to 79.8%. In this respect, the slowdown in economic activity that has characterized the latter part of this business cycle has been particularly serious in manufacturing.

There are several reasons for this. First, manufacturing and goods-producing industries in general are more vulnerable to inventory cycles. Although inventories were drawn down during the early stages of the recovery, in early 1984 a return to accumulation took place, bringing the inventory-sales ratio from a postwar low of 1.29 in January to 1.38 by the summer. At this juncture, however, business had apparently misgauged the extent of the slowdown in demand, leading to the emergence of an overhang of unsold stocks. Excess inventories were not substantially liquidated until late 1985, which accounts in part for the slowdown in manufacturing production.

A second factor has to do with the fact that goods-producing sectors are considerably more vulnerable to import penetration. As discussed in more detail below, a significant component of the slowdown in economic activity has been due to the decline in net exports, both as a result of sluggish growth in American exports but more importantly because of massive increases in imports of manufactured goods. The trade deficits that have characterized the 1983-85 recovery are distinctive inasmuch as, unlike the OPEC-induced trade deficits of the 1970s, they have been concentrated in manufactured goods rather than petroleum. The implications for the business cycle are serious. During the last two major periods of expansion, 1971-73 and 1975-79, the pace of economic

activity during the latter stages of the business cycle was sustained in part by major export booms, which were particularly pronounced following the devaluations of 1973 and 1978. By comparison, the fact that the exchange rate tended to appreciate on average until early 1985 meant that no export-led growth took place. Instead, the external sector worked in the opposite direction, depressing the growth rate of the economy from mid-1984 onward.

A third factor, which has been somewhat less significant, is that in manufacturing industries, both the growth rate of capital investment and the level of consumer demand are critically dependent on the cost and availability of long-term credit. From mid-1984 onward, both aggregate consumer activity and business fixed investment have slowed on average, although this must be qualified by the fact that the slowdowns were limited to particular quarters. If the individual weak quarters are factored out, both consumer spending and capital investment have held up remarkably well during the period of slower economic growth. The cost, however, has been that both business and consumers have leveraged themselves to potentially unsustainable levels in order to maintain the growth of spending. As of the third quarter of 1985, personal savings had been drawn down to a postwar low of less than 3% of disposable income, while consumer installment debt stood at roughly 18% of disposable income, a postwar record. Although business cash flow relative to debt service recovered from its depressed levels of the 1981-82 recession, corporate debt-equity ratios in 1985 were scarcely below their levels of 1983, indicating that business has by and large been willing to incur atypically high levels of debt. High levels of personal and corporate leveraging in turn imply an upper limit on the ability of domestic demand to sustain economic activity. At some point, the inability to incur additional debt and the need to reliquify could further slow the economy. Even if a recession does not emerge during the next

two years, high degrees of leveraging will militate against a return to rapid gains in economic activity.

While the proximate causes of slower growth have been due to the inventory cycle, the trade deficit and high interest rates, the indirect causes are closely bound up with the fiscal deficit. In this respect, the transition from rapid expansion to sluggishness in 1985 seems fully commensurate with the scenario outlined above in which bond-financed deficits generate an initial surge in economic activity followed by a compensatory downturn. There is also increasing evidence that the United States may be caught in the kind of vicious cycle described earlier, in which fiscal deficits and slow growth perpetuate each other. CBO estimates projecting deficits in the range of 4% of GNP and through the end of the decade are predicated on relatively favorable economic assumptions. A somewhat weaker economic performance, for instance in the event of a major slowdown or recession in 1987 or 1988, would raise the deficit above even these projected levels, and further aggravate a fiscal situation that already gives indications of near intractability.

3.3 Deficits and Interest Rates

The effects of the deficit on interest rates can be gauged through a brief overview of the behavior of short-term and long-term rates since 1983. Short-term interest rates, which are determined mainly by market forces, have been raised primarily through flow of funds mechanisms.

One indicator of the degree of pressure in credit markets is provided by the ratio of Federal borrowing to all funds raised, excluding equities. This ratio, which stood at only 15.1% in 1979, surpassed 34% in 1980-81, reaching 49.7% in FY 1982 and 56% in FY 1983. While initial estimates show this ratio falling 36.6% in FY 1984, the degree of "crowding out" in credit markets due to the

fiscal deficit has been and continues to be unprecedented by postwar standards. The effects on short-term interest rates are manifest. Econometric simulations indicate that short-term rates since 1981 have been significantly higher than can be accounted for by their prior behavior. The real short-term interest rate in the sense of nominal rates less inflation expectations is not directly observable, but the real rate of return as measured by nominal rates less actual inflation has been at unprecedented levels. In 1983 and 1984, the real prime rate stood at 7% and 8.2% respectively. The corresponding figures for the Federal funds rate are 5.3% and 6.4%.

With respect to long-term rates, levels appear to have been influenced both by pressure in credit markets and by inflation expectations. Econometric tests indicate that the level of long-term rates has been even higher than can be explained solely by the level of short-term rates, suggesting that fear of inflation due in large measure to the deficit has led to higher risk premia being built into rates on long-term loans. This supports the Rational Expectations hypothesis cited earlier that large fiscal deficits may raise interest rates through expectational channels. The real long-term rate of return on long-term government bonds stood at 7.5% in 1983 and 8.4% in 1984. The corresponding figures for fixed-rate 30-year mortgages are 8.7% and 8.5%. These are the highest real rates of return witnessed since the Great Depression of the 1930s.

While some commentators have argued that the deficit is not fundamentally responsible for the level of real rates since 1981, primarily on the grounds that there is no long run correlation between interest rates and deficits, this argument does not hold up under careful scrutiny. There was no long run relationship between deficits and the variance of interest rates prior to 1979 for two major reasons. First, deficits then tended to behave countercyclically,

rising during recessions and falling during recoveries. This meant that the Federal government's demand for credit correlated inversely with that of the private sector. Secondly, monetary policy normally pegged interest rates at levels that were commensurate with broad accommodation of the Federal borrowing requirement. However, because of the change in Federal Reserve operating procedure in October 1979, prior historical evidence is now substantially irrelevant to the issue of whether large deficits raise short-term rates. Further, while the crowding out process described above does not account for the variance of interest rates over the last few years, nevertheless it provides a powerful explanation for the average level of real rates of return. In the final analysis, therefore, the overly expansionist fiscal stance in conjunction with monetary policies which have remained essentially anti-inflationary goes quite far in explaining the level of long and short term rates over the past few years.

3.4 The Misalignment in Exchange Rates

The mix of tight monetary and loose fiscal policy is the single most important factor responsible for the appreciation of the dollar since 1981. The rise in U.S. interest rates and the resulting differential in real rates of return vis-a-vis other countries have led to increased world demand for dollars to purchase dollar-denominated financial assets. A related if secondary factor has been the increased volume of U.S. government debt instruments issued in global financial markets. To the extent that the large deficits projected for the balance of the decade cannot be financed by domestic borrowing, they will be financed through continued reserve inflows, thereby keeping the dollar overvalued. The extent of the appreciation of the dollar has also been unprecedented. Using the IMF's multilateral trade-weighted index, the dollar

appreciated by more than 60% between its trough in late 1980 and its peak in early 1985. Since this time, in the wake of massive intervention in global currency markets by the Federal Reserve and foreign central banks, the dollar has depreciated by about 25%. However, this still leaves it overvalued relative to purchasing power parity by about 30%.

The effects on the trade balance in manufactures have been disastrous. Since 1981, exports have fallen sharply as a share of production, particularly in instruments, aerospace, machine tools, and even in high technology, in which the United States enjoys some comparative advantages. During the same period, imports as a share of domestic consumption have surged, with particularly marked increases in certain consumer non-durables, general industrial machinery, machine tools, and even in computers and semiconductors. In 1985, the United States ran a massive trade deficit in manufactured goods. The trade accounts were in deficit in almost every category of manufacturing.

A major adverse result of the overvalued dollar that has not been accorded sufficient attention in the United States is the degree to which it has been directly responsible for the global nature of the 1981-82 recession. Here several causal mechanisms are involved. The interest rate differential between the United States and the other industrial countries has generated reserve flows, undercutting the balance of payments of foreign nations. At the same time, because the bulk of global trade is denominated in dollars, the appreciation of the dollar has raised import prices abroad, creating a severe problem of "imported inflation" in trade-dependent economies. Because of reserve outflows and the rise in import prices, the other industrial countries have been forced to apply restrictive policies in order to mitigate the interest rate differential with the United States, support their balance of payments, and prevent any further depreciation of their exchange rates against the dollar. In

this regard, they had very little choice. Countries that attempted to reflate experienced massive balance of payments deficits and devaluation crises, followed by mounting inflation due to the feed-through of import costs into domestic wage-price cycles. While restrictive demand management policies overseas prevented this from taking place, the cost was that the economies of the other industrial countries have remained chronically recessed.

This in turn has further undermined the American trade balance. Because demand overseas has been recessed, the market for American exports has been proportionately weaker. Similarly, inasmuch as foreign industrialists have encountered slack in domestic markets, they have responded by shifting to export markets, frequently in the United States. In this manner, the appreciation of the dollar has been responsible for the trade deficit not only through its direct effects on competitiveness, but also through its indirect effects on relative business cycles across national boundaries.

4. Toward A More Appropriate Fiscal Policy

4.1 The Economic Implications of Fiscal Restraint

Given the above, the most essential priority for Congress in the area of fiscal policy over the next few years is the implementation of a budgetary program more commensurate with macroeconomic stability. The recent Gramm-Rudman-Hollings (hereafter GRH) proposal, while not perfect, represents a step in the right direction. The long-term benefits of GRH could be substantial.

First, reductions in outlays will mitigate the current over-expansionary stance of fiscal policy and lower the risk of destabilizing the business cycle. In this manner, it will be possible to bring the economy closer to its long-term

equilibrium growth trajectory. In essence, a less stimulative fiscal posture will eliminate the current adverse range of choice between allowing the economy to overheat as it has during prior recoveries, or forcing interest rates to rise through non-accommodation of the fiscal stimulus.

Second, reductions in spending will facilitate a more permanent reduction in interest rates. This will take place through two channels. The reduction in aggregate demand resulting from spending cuts will lead to slower credit demand, and at the same time, lower Federal credit needs will mitigate the crowding out problem in capital markets. The lower deficit should also reassure financial decision makers that there is no further danger of an acceleration in inflation, which should lower the expectations premium on loans, permitting some reduction in long-term rates. In addition, reductions in both interest rates and the volume of Treasury securities issued in global financial markets will help to achieve a more realistic exchange rate for the dollar. This will generate an improvement in trade competitiveness, leading ultimately to higher employment. At the same time it will alleviate the balance of payments constraint on demand management in the other industrial countries, enabling them to pursue more expansionary policies, stimulating faster worldwide economic growth.

It should not be surmised of course that these benefits would necessarily emerge in the short run, or that a policy of systematic fiscal restraint would not involve substantial adjustment costs. Given the evidence that the near-term effects of fiscal policy on the economy take place primarily through income-expenditure channels, the immediate effects of fiscal restriction would in all likelihood consist of a downturn in economic activity. This, however, would be temporary, and over the medium-term the economy would return to or surpass its equilibrium growth trajectory. In the long run, the performance of the economy would undoubtedly be enhanced, with the full-employment budget in

surplus. In essence, the effects of fiscal restraint, like those of fiscal expansion, are likely to be asymmetric.

4.2 GRH: An Econometric Analysis

As a gauge of the effects of the GRH proposal on the economy, an independent econometric study by Lawrence Meyer and Associates, Inc. provides some useful evidence. In the event that fiscal restraint is imposed without offsetting monetary stimulus, the path of GNP would tend to be lower. It therefore makes more sense to look at the trajectory of the economy in a simulation in which the Federal Reserve pursues a sufficiently accommodative monetary policy to keep current dollar GNP on the same growth path as in the baseline. In this simulation, the following results emerge.

- Real GNP in constant dollars falls very slightly (0.3 percentage points) relative to the baseline in the first two years, and then converges back to the baseline. The output costs are therefore minimal.
- Interest rates fall substantially relative to the baseline. By the third year, rates are more than a pecentage point lower, and by 1991 when the budget is balanced, rates are 150 basis points lower than under current law.
- Because of the decline in interest rates, the user cost of capital declines and investment accelerates. By the end of the simulation, the growth rate of real business fixed investment is higher by 1.6 percentage points.
- Also because of the decline in interest rates, the dollar falls more rapidly. As a result, the economy undergoes a dramatic improvement in its trade accounts. By the end of the simulation, the improvement in net exports is in the area of $120 billion (in current dollars).

- A side effect of the faster depreciation of the dollar, however, is that the inflation rate is slightly higher, although by only 0.5 percentage points relative to the baseline.

In sum, there are substantial long-term benefits associated with the GRH deficit reduction program. Although there are minor costs in terms of lost output and rising prices, the long-term benefits include substantially lower interest rates, stronger growth in private investment, a lower dollar and a virtual elimination of the trade deficit.

While clearly preferable to no action at all, allowing the GRH program to work through the mandatory sequestering process would not be the optimal means of lowering the deficit. Instead, ideally, it would be desirable for Congress to come up with the spending reductions required to meet the GRH targets. Here, a series of measures could be applicable.

4.3 Deficit Reduction Techniques

The prim y strategy for lowering Federal deficits must emphasize reductions in the growth of Federal spending. Such reductions should be spread as evenly as practicable over all portions of the Federal budget, including Social Security and defense spending. To hold certain segments immune from reductions will jeopardize the entire fiscal control process. While the following list is by no means exhaustive, it provides several options which are worthy of consideration.

1) Curtailment of Entitlement Spending. Although the growth of transfer payments now appears to be in the process of leveling off and outlays for income transfers may undergo a modest decline over the next several fiscal years, nevertheless, the existing transfers will continue to work against efforts to reduce the deficit. For this reason greater control over income transfers is

required. At the very least, no new entitlement programs should be created. Preferably, given the pressure on outlays exerted by indexation, all existing indexed income transfer programs, including Social Security, should be indexed to something less than 100% of CPI increases. Here there seem to be two major options, either reducing the indexing formula by a specified number of percentage points (e.g., CPI increase minus 3%) or holding the indexing to a percentage of CPI increase (e.g., 60% of CPI). Both approaches would produce major savings over the long run.

2] Reductions in Defense Spending. The Administration's plan to raise defense spending while curtailing domestic programs is not equitable, to say nothing of lacking in political realism. In order to ensure that deficit reduction targets are met, the budgetary sacrifices must be spread over all categories of Federal outlays, including defense. Notwithstanding the needs of national security, there is ample evidence of waste and abuse in the defense procurement process that spending cuts can be enforced here without endangering the readiness of the country's armed forces.

3] Limits on Federal Credit Activity. Binding limits should be established for all Federal credit activity. Such limits should be enforced through the authorizations and appropriations process, primarily through dollar limitations. Funds for credit activities should also be subject to the same impoundment and reconciliation procedures that are mandated in the Congressional Budget Act for other types of activity. In other words, an equivalent degree of control should be exercised over both direct spending and credit programs.

6. Conclusions

The current stance of fiscal policy, in particular the large structural deficits that are projected to persist for the remainder of the decade, are not commensurate with macroeconomic stability; further, their impact will be particularly deleterious to manufacturing industries that are sensitive to high interest rates and vulnerable to import penetration. Recent initiatives to simplify the tax code, moreover, will merely compound the current difficulties of manufacturing by raising industry's effective tax liabilities, while failing to reduce the deficit. Instead, what is needed is a systematic plan to bring the deficit down to levels that will insure lower interest rates, a more realistic exchange rate and a stable business cycle. The adoption of fiscal targets commensurate with these objectives, for instance by bringing the budget into surplus at full employment, could go a long way toward setting the stage for future industrial prosperity.

The CHAIRMAN. Thank you very much, Mr. Dee.

Now we turn to our next witness, Frank Morsani, chairman of the Chamber of Commerce of the United States.

STATEMENT OF FRANK L. MORSANI, CHAIRMAN, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. MORSANI. Thank you, Mr. Chairman.

I am Frank Morsani, chairman of the board of the United States Chamber of Commerce and president of Precision Enterprises, Inc. of Tampa, FL.

On behalf of the chamber's membership, I welcome this opportunity to present our views on the fiscal year 1987 budget and to share with you our recommendations for meeting the requirements of the Gramm-Rudman-Hollings amendment by imposing firmer limits upon the growth of Government spending.

In our view, the chief cause of Federal budget deficits is a relentless growth in Federal spending. Our past difficulties in solving this problem led to the recent passage of the Gramm-Rudman-Hollings Act.

The effective solution to meeting the mandates of the act is to impose firm limits on the growth of Government and encourage the current economic expansion. Anything less than this—and I include tax increases in this category—will be ineffective and will reduce the prospects for economic growth.

And Mr. Chairman, I want to emphasize that the main objective of deficit reduction should be economic growth. Nothing can help all Americans more than a healthy, growing economy that produces more employment and more wealth for all of our society. All the Government jobs programs of recent years, for example, pale into insignificance when compared to what the current economic recovery has done to help people find jobs.

Since 1982, 9.9 million new jobs have been created, bringing our current work force to 109 million, the highest in our history. Economic growth is the best antipoverty program we can devise, and every effort should be made to encourage it.

While we share your concern about projected deficits, we view these as a symptom of a larger and more severe problem, Government overspending, which during the 1980's has outstripped the growth of the economy.

As I see it, the facts on the current budgetary situation are simply this. Since 1980, the real growth of Federal spending has averaged 3.9 percent annually, much more than the real growth of the economy, which averaged 2.3 percent. Also, since 1980 tax revenues have increased by $217 billion, an increase of 42 percent. However, Federal spending has gone up by more, rising by $355 billion, an increase of over 60 percent.

A spending limit approach to deficit reduction is also consistent with what the public desires. They overwhelmingly voted for a President in 1984 who promised to prevent the Federal Government from taking a larger share of their income with higher taxes.

The public knows that the economy functions better when it has greater control over its income. It also knows that the sources of

economic growth lie in the enterprising creativity of its people, not in the hundreds of programs administered in Washington.

We hope that Congress will use the Gramm-Rudman-Hollings Act to achieve what the public desires. The Congress demonstrated great courage in passing this legislation. It can continue to act in a fiscally responsible manner by reducing the costs associated with hundreds of Federal programs.

The chamber believes that the President's budget for fiscal year 1985 provides a useful guide for future budget deliberations. We applaud the President for proposing a bold budget plan for the next fiscal year and concur with his objectives of meeting the Gramm-Rudman-Hollings requirements with spending reductions. His resolve to steer clear of tax increases demonstrates his commitment to economic growth and freedom of choice.

However, we also believe that the President's budget does not go far enough. While we strongly endorse his efforts to reduce spending, we believe that it is essential to go further, particularly in the areas of defense and Social Security, which together constitute over half of all spending.

The inclusion of these additional measures of spending restraint will create a greater sense of equity and shared sacrifice.

An alternative budget proposal should include the following provisions. COLA's, including those for Social Security, should be frozen for fiscal year 1987 and should be less than 100 percent of the Consumer Price Index in subsequent years.

Second, spending for nondefense discretionary programs should be reduced to achieve savings comparable to those found in the President's budget.

Third, further savings in Federal pay, pension and Social Security programs can be obtained by making them more comparable to prevailing private sector norms.

Fourth, further defense savings should be achieved through managerial efficiencies and the implementation of the many recommendations provided by the Grace Commission, the GAO and the CBO.

Fifth, foreign subsidy programs must be fundamentally reformed to reflect savings comparable to those recommended for other programs.

Sixth, an aggressive privatization program should be carried out using such tools as sales of assets and Government/commercial enterprises, contracting out and vouchers.

Seventh, means-tested programs should be allowed an adjustment for inflation and new beneficiaries. However, to the extent possible, the recommendations of the President and others to improve targeting, efficiency, and management should be adopted.

Although programs important to our membership will bear some of the burden through substantial cuts, we are prepared to accept major changes in these programs if they are part of a comprehensive and far-reaching effort to reduce the deficit.

That concludes my remarks, Mr. Chairman. The chamber is delighted to find that the President and many Members of Congress intend to devote their efforts to a deficit reduction strategy that relies entirely on spending restraint. We applaud, again, the courage of Congress in passing the Gramm-Rudman-Hollings Act, and

we will devote much of our resources over the coming months to assist you to meet its requirements.

[Testimony resumes on p. 297.]

[The prepared statement of Mr. Morsani follows:]

Prepared Statement of Frank L. Morsani

I am Frank Morsani, Chairman of the Board of the U.S. Chamber of Commerce and President of Precision Enterprises, Incorporated of Tampa, Florida. On behalf of the Chamber's membership, I welcome this opportunity to present our views on the Fiscal Year 1987 (FY '87) budget and to share with you our recommendations for meeting the requirements of the Gramm-Rudman-Hollings amendment by imposing firmer limits upon the growth of government spending.

Summary

The chief cause of federal budget deficits is the relentless growth of federal spending. Our past difficulties in solving this problem led to the recent passage of the Gramm-Rudman-Hollings amendment. The effective solution to meeting the mandates of Gramm-Rudman-Hollings is to impose firm limits on the growth of government and encourage the current economic expansion. Anything less than this - and I include tax increases in this category - will be ineffective and will reduce the prospects for economic growth.

And, Mr. Chairman, the main objective of deficit reduction should be economic growth. Nothing can help all Americans more than a healthy, growing economy that produces more employment and more wealth for all of our society. All the government jobs programs of recent years, for example, pale into insignificance compared to what the current economic recovery has done to help people find jobs. Since 1982, 9.9 million new jobs have been created, bringing our current work force to 109 million, the highest in our history. Every time we cut back government to reduce the deficit, we must consider the trade off -- that trade off is economic growth, the best anti-poverty program we can devise. While we share your concern about projected deficits, we view these as a symptom of a larger and more severe problem -- government spending, which during the 1980's has outstripped the growth of the economy.

Since 1980 the real growth of federal spending has averaged 3.9% annually, much more than the real growth of the economy, which averaged 2.3%. Also, since 1980 tax revenues have increased by $217 billion, an increase of 42 percent. However, federal spending has gone up by more, rising by $355 billion, an increase of over 60 percent. This suggests to us that government spending is the chief cause of the deficit and that better control over outlays is the only solution.

This approach is also consistent with what the public desires. They overwhelmingly voted for a president in 1984 who

promised to prevent the federal government from taking a larger share of their income with higher taxes. The public knows that the economy functions better when it has greater control over its income. It also knows that the sources of economic growth lie in the enterprise and creativity of the people, not in the hundreds of programs administered in Washington.

We hope that Congress will use the Gramm-Rudman-Hollings amendment to achieve what the public desires. The Congress demonstrated great courage in passing Gramm-Rudman-Hollings. It can continue to act in a fiscally responsible manner by reducing the costs associated with hundreds of federal programs. In this way it is possible to avoid tax increases and keep our economy growing.

In anticipation that the Congress will be looking for opportunities to reduce the growth of federal spending, the U.S. Chamber and other major business associations will continue to lead the Deficit Reduction Coalition (DRC) toward the goal of achieving dramatic reductions in government spending growth rates and deficits over the remainder of the decade.

The Chamber believes that the President's budget for FY 1987 provides a useful guide for future budget deliberations. We applaud the President for proposing a bold budget plan for the next fiscal year and concur with his objective of meeting the Gramm-Rudman-Hollings requirements with spending reductions. His resolve to steer clear of tax increases demonstrates his

commitment to economic growth and freedom of choice.

However, we also believe that the President's budget does not go far enough. Further reductions and managerial efficiencies within the defense budget should be pursued, and a one-year cost-of-living adjustment (COLA) freeze should be extended to Social Security.

Although programs important to our membership will bear some of the burden through substantial cuts, we are prepared to accept major changes in these programs if they are part of a comprehensive and far-reaching effort to reduce the deficit.

I. Fiscal Choices

Federal budget policy in 1986 brings us to a crossroads. Record deficits, the failure to control the growth of federal spending, and the emergence of the Gramm-Rudman-Hollings amendment confront us with a critical choice. The choice is between a federal budget policy that continues to increase the government share of the public's income or a policy that places more control over resources in the hands of individuals.

The Chamber believes that the public prefers the latter. This preference is revealed in the election in 1980 and again in 1984 of a President who endorsed a policy of limited government and lower taxation. It wants more choice over how its income is spent and how resources are allocated. It knows that when it has

greater choice in these decisions, the economy functions better and that prosperity does not reside in a society where growing control over resources is routed through federal programs in Washington.

The kind of federal budget policy that produces the results we desire is no great mystery. It is a policy that stresses economic incentives, the role of the entrepreneur, and job creation. In order to achieve these goals, we must pursue a policy of limited federal spending and moderate taxation. Only when we lift the burden of excessive government and taxation are economic incentives nourished and the economy prospers.

The experience of many nations around the world attests to the validity of this view. For example, many European nations have ignored the dictum that economic prosperity goes hand in hand with limited government and low taxation, carrying public expenditures and taxation to exorbitant levels. Most of these nations are now in the midst of economic stagnation. Total government expenditures in Europe, as a percentage of Gross National Product (GNP), averaged 33% in the early 1960's and now stand at over 50% of GNP. Whereas economic growth rates in Europe averaged over 5% in the 1960's, these rates have tumbled in the 1980's to levels that are commonly below 2%. The results have been dire. As an example, the United States economy has created 9.9 million new jobs since 1982, but Europe has created no new net private jobs in the last 20 years. In Europe, the percentage of the working age population with jobs has shrunk,

and the unemployment rate has continued to increase since 1982 despite the economic recovery.

II. The Sources of Our Fiscal Problems

The major source of our fiscal problems is rooted in the relentless growth of federal spending. It took 160 years for federal spending to claim 10 percent of America's GNP, which it did in 1940. Since that time federal spending has risen to more than 24 percent of GNP. In recent times the trend continues. For example, federal spending, including Social Security, as a percentage of GNP stood at 20.5% in 1979 but has advanced to 24.0% in 1985. One major implication is that federal government growth has surpassed the growth of the economy.

Such facts are hardly a secret, and Congress has often tried to control the growth of federal spending. However, its good intentions have not always materialized. The problem is that Congress faces serious difficulties in implementing its own budget resolutions. In fact, over the past five fiscal years, actual spending has surpassed budget resolution targets by an average of $24 billion a year. This year's budget resolution is no exception. Recent analysis indicates that spending, without the Gramm-Rudman-Hollings sequester, would exceed the 1986 budget resolution by approximately $27 billion.

In large part, these problems are related to the federal budget process and the growing influence of special interests.

Representative democracy has the unfortunate side effect of making it possible for special interest groups to push through programs that create substantial benefits for themselves but inflict greater costs upon the rest of the electorate. James Madison recognized this problem as the "violence of the faction." This refers to the ability of a well organized minority to profit by legislation that disperses the cost of a federal program over the entire electorate. The former group has every incentive to organize because its per capita benefits are high and the latter fails to organize, because per capita costs are insignificant. The result is that many federal programs of questionable value are enacted.

The compromise FY '86 budget resolution, passed by Congress in late July, failed to incorporate important structural changes, such as a freeze on Social Security and other retirement COLAs. It substituted domestic program freezes and unspecified reductions for program terminations. Nearly half of the cuts came from defense spending.

The effects of the 1986 budget resolution have since become clear. Federal spending is on a path that will breach the budget resolution by a wide margin. Congress has found it difficult to enact a reconciliation bill to enforce the nearly $15 billion in proposed budget reductions. As a consequence, most of the domestic spending reductions contained in the budget resolution are not being enforced.

The recently enacted farm bill illustrates the difficulties associated with enforcing a budget resolution. It is expected that farm support programs will cost $20 billion in 1986, nearly $8 billion more than the amount specified in the budget resolution. The farm bill and the failure to enact reconciliation mean that the 1986 budget will be well over the amount specified in the budget resolution.

Such slippage, I believe, is one of the chief reasons why a large, bipartisan majority of both houses finally enacted the Gramm-Rudman-Hollings amendment. Something more was needed. When it became apparent that the 1986 budget resolution would not cut spending to the extent intended, it was time to consider procedural changes. Gramm-Rudman-Hollings, by setting binding budget targets, hopefully will lead to better results. Moreover, we feel the sequester will take some of the political heat off Congress. Special interests will know that Congress has no other choice.

III. Opportunities to Reduce Spending Growth and Cut the Deficit

The Gramm-Rudman-Hollings amendment forces us to confront the issues. The Chamber believes that Congress can take advantage of this opportunity to reduce the growth of federal spending. Nearly every portion of the federal budget contains areas worthy of consideration for budget reduction. Reputable sources, such as the Congressional Budget Office (CBO), The General Accounting

Offic (GAO), The Office of Management and Budget (OMB), the Heritage Foundation, the Brookings Institute, the Grace Commission and the Senate Finance Committee, have documented spending reduction opportunities that easily exceed $100 billion in one year alone.

The Chamber believes that Congress should avail itself of these opportunities. We strongly encourage you to take advantage of the numerous spending reduction proposals put forward by these organizations. If one considers the CBO and OMB estimate that the 1987 deficit will be less than $40 billion over the target deficit of $144 billion, one can agree that this is not an exceptionally large amount of budget savings to accomplish in one year. More than this was attempted last year and nearly achieved.

In an effort to reach this objective, Congress once more should consider reform of entitlement programs. Such a policy is warranted in light of the large subsidies given to present retirees. Future generations will not fare so well. They will confront billions of dollars of unfunded liabilities and they will receive a poor return on their contributions to such programs. For example, according to some estimates, today's 20-year-old will receive 72 cents for every dollar he puts into the Social Security system. Consequently, it is important that Congress implement such reforms as COLA freezes in federal pension and Social Security programs and higher co-payments and fees for Medicare beneficiaries.

In the nondefense discretionary area, substantial savings can be made in hundreds of programs ranging from Amtrak to the Rural Electrification Administration. Special attention should also be given to reducing the cost of price supports for agriculture.

We should continue to seek efficiencies within the Department of Defense. Base closures, pay reform, contract efficiencies, greater use of contracting out, and other cost savings should be pursued. A recent GAO report, for example, studied 20 Department of Defense functions that has been contracted out and found that cost savings were realized in 17 of them.

Numerous studies by the President's Private Sector Survey of Cost Control, GAO, and CBO have discovered many areas within the Department of Defense where substantial cost savings could be achieved without jeopardizing our national security. We encourage you to continue to review these many proposals and urge their adoption where appropriate. Further, we hope that the so-called Packard Commission will soon recommend additional ways to stretch the defense dollar.

Congress should also take advantage of an exciting and relatively novel method to achieve spending reduction - privatization. Privatization refers to the process of shifting a portion of public-sector activities to the private sector. The

advantage of privatization is that public programs are not eliminated but shifted to the more efficient private sector. Consequently, program beneficiaries need not be alienated through loss of service or benefits. Privatization can take many forms, such as the sale of public assets and commercial activities to private interests, contracting out, and the utilization of vouchers. Privatization can help substantially in reducing the budget deficit. For example, Great Britain's recent experiment with privatization has added over $20 billion to its treasury.

To us the message is clear. Spending cuts are preferred to tax increases. The basic prerequisite for a strong and growing economy is limited taxation. Studies by the World Bank and the Organization for Economic Cooperation and Development (OECD) indicate that those countries with high rates of economic growth have low tax rates and those with a persistent pattern of stagnation have high taxes and burdensome government. Countries that continue to grow and enrich their populations have economic systems that reward work, enterprise, and creativity. But these incentives cannot be maintained with a budget policy that feeds runaway spending by burdening workers and businesses with rising levels of taxation.

As Congress reconvenes and begins to develop next year's budget, the discussions about what to do to reduce the deficit focus increasingly on proposals to levy an oil import fee or to increase the gasoline excise tax. Admittedly, there is a certain attraction to such a tax now that oil prices have fallen

so sharply. For some, such a tax is viewed as "costless," inasmuch as it could be structured such that oil and gas prices remain at the levels reached last year. To adopt such a tax, however, would deny the economy an important source of stimulus for this year and next and would be offset, in part, by diminished revenues elsewhere. Such a tax could also be regressive and have disproportionately severe impacts on some regions of the country.

An additional and compelling argument against oil and gas taxes is that they would deprive all Americans of a benefit they deserve. For over a decade, Americans have been paying the inflationary and other costs of a cartel-imposed price on oil. In addition, billions have been spent on energy conservation. After all these sacrifices, Americans deserve the benefits of falling oil and gas prices. They have earned them. Let's not deprive them of their just rewards.

Our simulations using the Washington University econometric model of the U.S. economy indicate that a $5 dollar-per-barrel decline in the price of oil would add $16 billion or a half of a percent to real GNP this year and $36 billion or almost a full percentage point to real GNP in 1987. The price decline also would create an additional 800,000 jobs over this year and next and reduce the budget deficit by $10 billion dollars over the same period. The projected deficit reduction follows from the higher business and personal incomes which lead to greater tax revenues. I might note that studies of

the oil price decline by Data Resources Inc. and Wharton Econometric Forecasting Associates came to essentially the same conclusions with regard to the impact on GNP.

We must realize that massive tax increases will not reduce the deficit and may even worsen it by diminishing economic growth. All too often, the logic behind a tax increase is based on a faulty accounting perspective of tax revenue. The argument is that tax revenues expand by the increase in the tax rate multiplied by the existing tax base. However, this static estimate of tax revenues fails to take into consideration the disincentive effects of higher tax rates upon the tax base. Specifically, rising tax rates mean less economic growth, less income and profits, and less tax revenue. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) illustrates this point. In conjunction with modest decreases in some spending, TEFRA, when enacted, promised a $103.9 billion deficit in FY '83 and an $83.9 billion deficit in FY '84. These targets, of course, were never achieved, in large part because actual spending exceeded targets by a substantial margin.

IV. The President's Budget and a Course for the Future

The Chamber firmly believes that there is ample room on the expenditure side of the federal budget to meet the requirements of Gramm-Rudman-Hollings. For this reason, the Chamber supports the goals of the President's 1987 budget. The

key feature of this budget is its resolve to reduce the federal deficit with spending reduction and to avoid tax increases. This reflects the Administration's desire for economic growth and its recognition of the disincentive effects of taxation. We applaud its awareness of the opportunities available for spending reduction.

The President's budget focuses on the nondefense portion of the budget with special emphasis on its discretionary component. The Chamber agrees that there is much that can be accomplished in this budget area. The Chamber does so knowing that programs important to our membership will bear some of the burden through substantial cuts. The President's budget also takes the initiative in implementing privatization measures. The Chamber also believes that privatization is a creative and bountiful source of spending reduction.

Nevertheless we believe that the President's budget can be improved. While we strongly endorse his efforts to reduce spending, we believe that it is essential to go further in the areas of defense and Social Security, which together constitute over half of all spending. The inclusion of these additional measures of spending restraint will create a greater sense of equity and shared sacrifice. A budget proposal should include the following provisions:

o COLAS, including those for Social Security, should be frozen for FY '87, and should be less than 100 percent of the

Consumer Price Index in subsequent years.

o Spending for nondefense discretionary programs should be reduced to achieve savings comparable to those found in the President's budget.

o Further savings in federal pay, pension, and Social Security programs can be obtained by making them more comparable to prevailing private-sector norms. CBO's recommendations along these lines are useful and include limiting the increase in Social Security bend points, lengthening the Social Security benefit computation period, reducing benefits for federal workers who retire early, and reducing in-grade pay raises for federal workers.

o Further defense savings should be achieved through managerial efficiencies and the implementation of the many recommendations provided by the Grace Commission, the GAO, CBO.

o Farm subsidy programs must be fundamentally reformed to reflect savings comparable to those recommended for other programs.

o An aggressive privatization program should be carried out, using such tools as sales of assets and government commercial enterprises, contracting-out, and vouchers.

o Means-tested programs should be allowed an adjustment for

inflation and new beneficiaries. However, to the extent possible, the recommendations of the President and others to improve targeting, efficiency and management should be adopted.

With this prologue, the Chamber is delighted to find that the President and many members of Congress intend to devote their efforts to a deficit reduction strategy that relies entirely on spending restraint. We applaud the courage of Congress in passing the Gramm-Rudman-Hollings amendment, and we will devote much of our resources over the coming months to assist you to meet its requirements.

The CHAIRMAN. Thank you very much, Mr. Morsani.

Now, Robert Kilpatrick, who is the chairman of the Budget Task Force of the Business Roundtable.

STATEMENT OF ROBERT D. KILPATRICK, CHAIRMAN, BUDGET TASK FORCE OF THE BUSINESS ROUNDTABLE

Mr. KILPATRICK. Mr. Chairman, Mrs. Martin and members of the committee, I am pleased to present to you the views of the Business Roundtable on the Federal deficit and on the President's budget.

Mr. Chairman, the conference report accompanying Gramm-Rudman-Hollings says that law, and I quote, "may be cited as the Balanced Budget and Emergency Deficit Control Act of 1985." From that citation, I want to call attention to the word "emergency" in the title.

Congress and the President did agree in December that the deficit is an emergency. The law even defines success in dealing with the deficit problem by setting specific deficit limits through fiscal year 1991.

While the Roundtable would have preferred to reduce the deficit even more rapidly than the law now requires, many of us are very encouraged by the determination of both the administration and the Congress in enacting the deficit limits of Gramm-Rudman-Hollings.

We believe these limits constitute a joint commitment by the Congress and the administration to the American people to fully face up to the emergency that is the deficit problem.

The financial markets also responded very positively to Gramm-Rudman-Hollings. A large number of us in the business community clearly believe Congress and the administration are serious about coming to grips with this very important issue. We believe this commitment remains unaffected by the district court ruling declaring the sequester process unconstitutional.

We continue to believe that the Congress has committed itself to cut the deficit.

The President now has taken the first step in accordance with Gramm-Rudman-Hollings. He submitted his proposed budget on time and in a manner that he believes meets the requirements of the law. The committee may disagree with the priorities in his proposed budget. It may question whether the budget, if enacted, would reduce the deficit as much as the administration projects. But the need for action now is in the hands of this committee.

Mr. Chairman, the Roundtable supports the President's approach to reducing the deficit, that is, with the primary emphasis on spending restraint. We have long advocated that spending reduction must be given the first priority in deficit reduction.

We agree with the President that Government should not compete with the private sector. We believe the country needs a strong national defense and that some Federal programs and activities are going to have to be eliminated, but we also believe Congress can improve on the President's budget.

Mr. Chairman, let me briefly address several specific areas of Federal spending. The Roundtable believes the country needs a

strong national defense, but the defense budget deserves the same scrutiny as other areas of Federal spending.

We are concerned, for example, that while Congress and the President have proposed to cut defense spending, as yet no defense programs have been cut. To do so may require some difficult choices, but they must be faced. The Packard Commission report is due soon. We hope Congress and the President can use that report as the basis for a new and demanding examination of our defense program.

A major deficit reduction package clearly must include defense cuts, but just as clearly, those cuts must not jeopardize our national security.

Congress also must examine the Social Security Program for possible savings. The Roundtable believes Social Security reforms can be achieved without harming the financial security of the elderly. Social Security is not self-financed. American taxpayers pay for Social Security, just like they pay for all other Federal programs.

Social Security benefits are not needs tested. Some Social Security recipients may need more money than they receive under current law, but increasing automatically all Social Security benefits while we are cutting back almost every other area of Government seems unnecessary, at best, and bad public policy, at worst.

We believe that permanent structural change in entitlement programs is a necessary component of any credible plan to move the budget back toward balance, and Social Security is by far the largest entitlement in the budget.

Congress also must consider for reduction certain so-called middle class entitlements, including farm price supports, student loans and other similar programs. The Business Roundtable believes that further benefit cuts in means-tested programs which impact the truly poor should be avoided if at all possible.

One final word, Mr. Chairman, on spending cuts. One must question whether or not it is time that Congress asks: Would we pass a law today if one did not already exist to pay for Amtrak, urban development action grants, or Eximbank, or to provide low cost electric power for some areas of the country? If not, in these times of the deficit emergency, shouldn't many of these existing laws be carefully reconsidered?

This is not to say that the Roundtable supports all of the program eliminations proposed in the administration's budget. We do urge, however, that you carefully consider all of the President's proposed program eliminations, a step that would help to ensure the credibility of a comprehensive deficit reduction package.

Mr. Chairman, I would like to spend just a minute discussing revenues. As businessmen, we believe Congress should cut spending as much as possible in every area of the budget before it considers new or increased taxes, even if those taxes are targeted to cut the deficit.

The Roundtable is very concerned that many seem ready to turn first to the revenue side of the budget. The Roundtable believes that tax reform should be set aside while Congress and the administration concentrate on reducing the Federal budget deficit.

An increase in revenues might be required to solve the deficit problem, but this would be acceptable only as part of a package with major spending restraints.

I would add, Mr. Chairman, as a personal aside that such a revenue increase should not be in addition to the $140 billion of new corporate tax increases already proposed under H.R. 3838.

In summary, Mr. Chairman, let me say that the Business Roundtable continues to believe that the most crucial economic problem facing the United States is the size and trend of the Federal deficit. Budget deficits are adding to the enormous burden of the public debt, threatening the long-term health of the economy, fueling the growing trade deficits, costing jobs and risking a new wave of inflation.

We are aware that Congress and the President have made great strides in their plans for deficit reduction, and we should not lose sight of that. Two years ago the deficit was climbing and the Congressional Budget Office warned that a recession could produce deficits of over $300 billion or more per year.

Today at least the situation seems to have been stabilized.

We urge the committee to meet the deficit requirements of the Gramm-Rudman-Hollings law, to meet them this year, next year and in every year. Continued stability and a strong national economy will depend in part on such continued progress by Congress.

The Roundtable, Mr. Chairman, is prepared to work with you, with the House, your colleagues in the Senate, the administration and others involved in the public policy process to achieve sound long-term solutions to the deficit problem.

Mr. Chairman and members of the committee, this concludes my testimony. I thank you again for providing the Roundtable with the opportunity to appear before you.

[Testimony resumes on p. 307.]

[The prepared statement of Mr. Kilpatrick follows:]

PREPARED STATEMENT OF ROBERT D. KILPATRICK

Mr. Chairman, members of the Committee, I am Robert D. Kilpatrick, Chairman and Chief Executive Officer of CIGNA Corporation. CIGNA is one of the nation's largest insurance holding companies, reporting revenue for 1985 in excess of $16 billion and having assets of almost $45 billion. Through its subsidiaries, CIGNA offers a full line of insurance and financial services, focused primarily on the commercial market.

I appear before you today, however, in my capacity as Chairman of the Business Roundtable Budget Task Force. I am pleased to present to you the views of our organization on the Federal deficit and on the President's budget.

Mr. Chairman, the Conference report accompanying Gramm/Rudman/Hollings says that law "may be cited as The Balanced Budget and Emergency Deficit Control Act of 1985." From this citation I want to call attention to the word "emergency" in the title.

Congress and the President did agree in December that the deficit is an emergency. The law even defined success as dealing with the deficit problem by setting specific deficit limits through FY 1991. While the Business Roundtable would have preferred to reduce the deficit even more rapidly than the law now requires, many of us are very encouraged by the determination of both the Administration and the Congress in

enacting the deficit limits of Gramm/Rudman/Hollings. We believe these limits constitute a joint commitment by the Congress and the Administration to the American people to fully face up to the "emergency" that is the deficit problem.

The financial markets also responded very positively to Gramm/Rudman/Hollings. A large number of us in the business community clearly believe Congress and the Administration are serious about coming to grips with this very important issue. And we believe this commitment remains unaffected by the district court ruling declaring the sequester process unconstitutional. We continue to believe that the Congress has committed itself to cut the deficit.

The President now has taken the first step in accordance with Gramm/Rudman/Hollings: He submitted his proposed budget on time, and in a manner he believes meets the requirements of the law. The Committee may disagree with the priorities in his proposed budget; it may question whether the budget, if enacted, would reduce the deficit as much as the Administration projects; but the need for action now is in the hands of this Committee.

Approach to Deficit Reduction

Mr. Chairman, the Business Roundtable supports the President's approach to reducing the deficit--that is, with the primary emphasis on spending restraint.

We have long advocated that spending reduction must be given the first priority in deficit reduction. We agree with the President that government should not compete with the

private sector. We believe the country needs a strong national defense and that some Federal programs and activities are going to have to be eliminated. But we also believe Congress can improve on the budget.

Review of Specific Programs

Mr. Chairman, let me briefly address several specific areas of Federal spending.

The Business Roundtable believes the country needs a strong national defense, but the defense budget deserves the same scrutiny as other areas of Federal spending. We are concerned, for example, that while Congress and the President have proposed to cut defense spending, as yet no defense programs have been cut. To do so may require some difficult choices, but they must be faced.

The Packard Commission Report is due soon. We hope Congress and the President can use that report as the basis for a new and demanding examination of our defense program. A major deficit reduction package clearly must include defense cuts; but, just as clearly, those cuts must not jeopardize our national security.

Congress also must examine the social security program for possible savings. The Business Roundtable believes social security reforms can be achieved without harming the financial security of the elderly.

Social security is not self financed. American taxpayers pay for social security just like they pay for all other Federal programs, and Social security benefits are not

needs-tested. Some social security recipients may need more money than they receive under current law. But increasing automatically all social security benefits, while we are cutting back almost every other area of government, is unnecessary at best and bad public policy at worst.

We believe that permanent structural change in entitlement programs is a necessary component of any credible plan to move the budget back toward balance and Social security is by far the largest entitlement in the budget.

We also believe that Congress should consider social security and medicare in tandem. The Administration's budget proposes substantial cuts in the medicare program, but much of this appears to be simply cost shifting. We agree that medicare cannot continue to grow as it has in the past; but we believe that medicare reform is realistically achievable only in the context of a re-examination of the whole social security system.

COLA reforms and/or taxing social security the same way we tax other retirement benefits could significantly reduce the deficit. Congress may want to consider additional options, but we continue to believe that social security must be a part of any major deficit reduction effort.

Congress also must consider for reduction all middle class entitlements including farm price supports, student loans and other similar programs.

We understand the farm economy is facing serious difficulties; but the best farm bill Congress could pass would be a major deficit reduction package. Farmers are like

everyone else in export sensitive, interest rate sensitive industries. They suffer severely from high deficits, high real interest rates, and an over-valued dollar.

Student loans may at times be necessary and appropriate; but heavily subsidized loans to students from middle income families are not.

These are only a few examples of programs which benefit middle income families, in which Congress can achieve substantial budget savings.

Middle income families also pay the lion's share of taxes. Whatever you do, middle income Americans will bear the brunt of balancing the Federal budget. Congress must ask itself if your constituents would prefer to pay higher taxes for these programs, or if the voters back home wouldn't prefer that you cut spending instead.

The Business Roundtable believes that further benefit cuts in means-tested programs which impact the truly poor should be avoided if at all possible.

One final word on spending cuts. One must question whether or not it is time that Congress asks: Would we pass a law today if one did not already exist -- to pay for Amtrak, Urban Development Action Grants, or Ex-Im Bank, or to provide low cost electric power for some areas of the country? If not, in these times of the deficit "emergency," shouldn't many of these existing laws be carefully reconsidered?

This is not to say the Business Roundtable supports all the program eliminations proposed in the Administration's budget. We do urge, however, that you carefully consider all

of the President's proposed program eliminations -- a step that would help to ensure the credibility of a comprehensive deficit reduction package.

Revenues

Mr. Chairman, I would like to spend a minute discussing revenues.

As businessmen, we believe Congress should cut spending as much as possible in every area of the budget before it considers new or increased taxes, even if they are targeted to cut the deficit. The Business Roundtable is very concerned that many seem ready to turn first to the revenue side of the budget.

The Business Roundtable believes Tax Reform should be set aside while Congress and the Administration concentrate on reducing the Federal budget deficit. We recognize that an increase in revenues might be required to solve the deficit problem, but this would be acceptable only as part of a package with major spending restraints.

Summary

Mr. Chairman, let me say in summary that the Business Roundtable continues to believe that the most crucial economic problem facing the United States is the size and trend of the Federal Deficit. Budget deficits are adding to the enormous burden of public debt, threatening the long-term health of the economy, fueling the growing trade deficits, costing jobs and risking a new wave of inflation.

We are aware that Congress and the President have made great strides in their plans for deficit reduction. Two years ago the deficit was climbing, and CBO warned that a recession could produce deficits of $300 billion or more per year. Today, at least, the situation has been stabilized.

We urge the Committee to meet the deficit requirements of the Gramm/Rudman/Hollings law: to meet them this year, next year and in every year through FY 1991. Continued stability and a strong national economy will depend in part on such continued progress by Congress. The Business Roundtable is prepared to work with you, your colleagues in the Senate, the House, the Administration and with others involved in the public policy process to achieve sound, long-term solutions to the deficit problem.

Mr. Chairman, Members of the Committee, this concludes my testimony. I thank you again for providing the Business Roundtable with the opportunity to appear before you to share our views on the deficit issue.

The CHAIRMAN. Thank you very much, Mr. Kilpatrick.

Let me just ask a series of brief questions to each of you, which you can answer in very short yes, no, or maybe terms.

As I have listened to you, it is my impression that the National Association of Manufacturers is freezing the COLA's of Social Security. Is that correct, Mr. Dee?

Mr. DEE. I think that that point was covered. Did you speak to that?

Mr. MORSANI. Right.

The CHAIRMAN. Well, I know that is the chamber's position, but what of the National Association of Manufacturers? Do you have a position on the COLA?

Mr. DEE. Mr. Chairman, it is our belief that in the current crisis that is facing our country, it is a desirable thing to freeze such COLA's for this year and to have future COLA's increase at a rate less than the CPI.

The CHAIRMAN. OK. And Mr. Morsani, the chamber, says freeze the COLA's?

Mr. MORSANI. Correct.

The CHAIRMAN. And Mr. Kilpatrick you used the word "touch" the COLA's, which implied something less than a freeze.

Mr. KILPATRICK. Mr. Chairman, we would be in favor of a freeze provided it was part of a well thought out package and everyone shared their part of the deficit reductions.

The CHAIRMAN. Let me ask another question, starting with Mr. Dee again.

Each of you seemed to imply that something needed to be done on the defense side, that you were not in agreement with the President's defense target. Could you give me what your organization's position is on what the defense numbers ought to be? As you know, the President calls for 12 percent growth. What is your organization's viewpoint?

Mr. DEE. Yes, sir. We do believe that it would be in the public interest to have the defense budget increase at a lesser pace than that indicated in the budget. As you know, it is claimed that the increase for 1987 would be 3 percent. As I stated in my testimony, if you use the actual amount appropriated for the prior year and you use that as a base point, the increase would be 11.5 percent, or about 8 percent after inflation.

In view of the spending reductions that are going to have to occur across a broad range of government, the NAM does not believe that the defense budget should be exempt from such reductions.

The CHAIRMAN. I'm sorry; maybe I missed it, Mr. Dee. Is there a percentage of real growth that the NAM stands for: 3 percent, 4 percent, 2 percent?

Mr. DEE. We have not identified a specific number, but it certainly should be less than the 8-percent real growth that we believe is indicated in the current budget.

The CHAIRMAN. All right. Mr. Morsani.

Mr. MORSANI. We have not specified a specific percentage. We think that the defense need should be looked at in the broad perspective and look for it there. We are not defense experts.

The CHAIRMAN. Mr. Kilpatrick.

Mr. KILPATRICK. Mr. Chairman, we believe that the defense budget should be on the table along with everything else. We clearly believe that the Nation needs a strong defense, but we also need a strong economy in order to defend ourselves. So, without defining a percentage, we nevertheless hope that the Packard Commission gives us some help there, and we believe defense clearly should be reduced somewhat below the President's level.

The CHAIRMAN. You don't have a specific figure, but you don't agree with the level of the President.

Mr. KILPATRICK. That is correct.

The CHAIRMAN. OK.

Exim; what is your organization's position on Exim? I understand, Mr. Kilpatrick, that you mentioned it by name, implying that your organization, the Business Roundtable, would be opposed to Exim—in other words, are you for the elimination of Exim?

Mr. KILPATRICK. We are not opposed to the elimination of the Eximbank or reducing the role of the Eximbank, Mr. Chairman, if it was part of a well thought through package and that happened to be one of the programs that had to make its contribution as well as many others.

The CHAIRMAN. In other words, you are talking about a reduction but not necessarily elimination?

Mr. KILPATRICK. It could be elimination or it could be a reduction if it was part of a total package.

The CHAIRMAN. Mr. Morsani.

Mr. MORSANI. Our view is exactly the same. Depending on what the mix is going to be, we think that Eximbank—I think they would be willing to take their portion of the cut, too, but we are not going to say we should eliminate the Eximbank. Let's see what falls out.

The CHAIRMAN. Mr. Dee.

Mr. DEE. Mr. Chairman, as has been stated a couple of times, we are in full support of the concept of getting everything out on the table. Nothing should be sacrosanct, including the latter item that we are discussing.

The CHAIRMAN. On taxes, Mr. Dee, is it my impression that your organization is opposed to any revenues for deficit reduction.

Mr. DEE. We believe that taxation is not a desirable way to go. We believe that the full attention of the country and of the Congress should be focused on bringing expenditures under control, reducing spending, and only after that has occurred, after we see how far we have been able to walk down the pike, should you consider any other alternative.

The CHAIRMAN. Mr. Morsani, I got the impression yours was a little bit stronger than that; no taxes, no way, no how.

Mr. MORSANI. That is correct. Here we are, especially with the recent drop in oil prices—we think we have an excellent opportunity to finally make the United States competitive internationally, and any taxes imposed at this time would be exactly the wrong thing to do for our economy when you are going to be looking at Japan and Western Europe, who is going to be expanding at a great rate, and the business community will be able to capitalize on that.

The CHAIRMAN. Mr. Kilpatrick.

Mr. KILPATRICK. Mr. Chairman, I have said that the Roundtable recognizes that revenues might be needed. I want to place the first emphasis, however, on spending restraint and to say that I believe, while I think some of the assumptions are optimistic, almost to the point of being rosy, I believe we have a chance of achieving the deficit reduction goals we need without any tax increases whatsoever.

I am concerned with the possibility of a double taxation on business that could cause very detrimental effects. That is why I particularly said that I think tax reform or tax increases or whatever you want to call them should be put on a lower priority and we should get an agreement on spending and then decide what revenues the Government needs.

The CHAIRMAN. So, as I understand it, NAM would say cuts in spending only, and might reluctantly look at revenues; the chamber would say, no on revenues; the Business Roundtable would emphasize cuts in spending first, then maybe revenues. These are very interesting positions. I am sure you are aware that Senator Domenici of the Senate has already called for revenues, and this morning on CBS he again mentioned the issue of the need for revenues and that cutting alone will not get us out of it.

I will now call on the gentlelady from Illinois, Mrs. Martin.

Mrs. MARTIN. We know the chairman's feelings in that area. If we had listened to the organizations that the three gentlemen represent in years gone by, we might not be in the trouble we are in today, too, in terms of deficits, I must say.

I just want to go a little further with the tax question so there is no confusion here.

Would it be fair to suggest you are saying for at least the first year look at spending before we impose on the creative spirit of American enterprise?

Mr. MORSANI. I was going to say absolutely.

Mrs. MARTIN. OK. Again, and you can do more than that. It is really all right.

May I make a statement, and then when I finish it, you tell me where I am wrong. I just want to be sure I have understood what I have both read and heard from you.

Overall, you would accept the President's recommendations, or at least the President's numbers in nondefense, domestic spending. You might vary slightly program to program. You would give us that option. But those dollars, the $23 billion, that that is a wonderful idea.

You would then look at the defense number and indicate that the President has not, in your view, achieved a savings commensurate with the need for cutting the deficit. In other words, you are not saying take money from defense and put it back in these other programs.

Mr. DEE. No; no; we are saying that defense ought to be on the table; indeed, that everything should be on the table, defense, entitlements, along with all the other items.

Mrs. MARTIN. Mr. Dee, but the problem here is everything always is on the table. We just keep feeding it more. You know, we are trying to get to where we can, in effect, strangely enough, take things off the table and say, By golly, we are going to cut this much from them.

So, all I am trying to figure out is are you intending to be at least in agreement, from your statements, with the President's domestic spending totals, but in disagreement, you would like more from the defense spending total?

Mr. KILPATRICK. I would answer it this way, Mrs. Martin. I would say that in concept, we agree with the President. We believe, and I think all of us have said, and I know I have said we should go further than the President has talked about. In specific, Social Security should be on the table, not suggesting what should be done, but it should not be removed from the table as the President's budget has suggested that it should be.

Mrs. MARTIN. Facing that horrible truth that it is, though, there probably is not going to be an undercurrent from the House to put it back on the table. Again, trying to look at the realities of what we face here—and I understand your feelings on Social Security, and you might be surprised at the support you have—but putting that aside from a moment, are you all at about the number that the President achieves in nondefense cuts but you would like him to achieve more in defense cuts? Is that about where we are?

Mr. KILPATRICK. I think there is a strong possibility that upon close examination, that the defense budget has been understated by a bit; that is, that it is actually somewhat larger than the President's budget shows that it is.

Now, if that is true, I think the problem that you have to deal with may be $15 billion or so larger than you otherwise might have thought. So, while it would be nice to get the $23 billion out of the nondefense part of the budget, it is my belief that it may be somewhat larger than that in order to get to the Gramm-Rudman limitations, and therefore, you need to look hard at the defense number itself once you get it right.

Mrs. MARTIN. I think I understand. I will admit I am not sure. I am not sure at all I just understood that. You think we should get more than $23 billion from nondefense?

Mr. KILPATRICK. There are reports that the defense increase is actually $15 billion larger. If that stands up under further examination, the problem that this committee faces is $15 billion bigger. And if that is true, then you have to get that much somewhere, either out of the defense budget or out of the nondefense side.

The CHAIRMAN. The Chair recognizes the gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Chairman, I have a series of questions to different people. I am not asking each one to respond.

To Mr. Morsani, I notice on page 2 of your testimony where you are talking about since 1980 the real growth of Federal spending has averaged 3.9 percent annually, you say that since 1980, tax revenues have been increased by $217 billion. You say, "However, Federal spending has gone up by more, rising by $355 billion, an increase of over 60 percent."

Now, I have looked at the budget documents, and your $355 billion figure, if I understand correctly the components of that, $119 billion of that is in defense, $77 billion of that is in interest on the national debt, and that is a total of $196 billion of this $355 billion that you cite is accounted for in those two items, in increases in defense and increases in the national debt.

So, I don't know that it is accurate to blame the size of the deficit on domestic spending, and I don't know, are you trying to suggest that it should be blamed on domestic spending or are you suggesting that it is overall spending, which includes this big increase in defense and this big increase in interest on the debt?

Mr. MORSANI. No; we are saying in total expenses, sir. It is not relegated to just domestic spending.

Mr. FROST. So, you are not suggesting that domestic spending is the reason why we——

Mr. MORSANI. It is only one component of it. I mean I think the two components that you mentioned are a part of it.

Mr. FROST. Yes; they are the two largest single components, of course, in terms of percentage growth. I just wanted to make that clear.

Mr. MORSANI. I understand your point.

Mr. FROST. Also, I wonder if any of you gentlemen are familiar with the study that the Congressional Budget Office did last year? It was a study, I believe, done for Mr. Obey, the chairman of the Joint Economic Committee, and it was looking at the 1985 fiscal year budget deficit. My recollection, and I may be off a few dollars, but my recollection is that of that $200-billion plus deficit in 1985, the Congressional Budget Office estimated that $130 billion of that deficit was directly attributable to the 1981 tax cut, to the Hance-Conable bill.

I was just wondering if you are familiar with that and if you in any way agree that the 1981 tax bill was a significant contributor to the deficit that we are currently facing; that that was the study for 1985, it certainly would be true for 1986 also?

Mr. KILPATRICK. Mr. Frost, I would have to answer that this way; that the deficit that we face is a combination of a lot of circumstances, one of which might be the tax cuts, one of which would be slow economic growth in the early part of the decade, the recession in the early eighties, the programs that were enacted back in the sixties.

There is almost enough credit or blame to go around, regardless of how we may pin it down. I think our current problem is one of getting a package of spending restraint and then looking at revenue if that doesn't do the job.

Mr. MORSANI. I will address it, Mr. Frost. I don't happen to agree with your conclusion in that I think that the tax cut of 1981 fostered all the jobs that have been created in the last 6 years. Furthermore, I refer you to the 1982 tax reform bill, TEFRA, when we fought to put a freeze on COLA's at that time. And what happened in 1982, we were promised a $103.9 billion deficit in 1983, and we actually ended up with—these targets were exceeded by—I have forgotten what it was now in 1983 and 1984, and I would think that the TFRA of 1982 was more of a culprit for the problems of today, and I think 1981 created the expansion we have been privileged to have in this nation.

Mr. FROST. My time is up, Mr. Chairman.

The CHAIRMAN. The gentleman from Oregon, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman. It's a pleasure to have you gentlemen here today.

Mr. Dee, I just have an observation. I am in the newspaper business when I am in the real world and have about 300 to 400 employees. And I am just curious, in your testimony, you recommend some kind of a bipartisan commission. Unfortunately, that's what we already have, and it's called the Congress of the United States, and we're unable to get to a resolution even when the facts are very clear. So, be careful about trying to urge this Congress to hand over to a few people what should be done here.

I have tried to push for a freeze on all spending, which I think listening to you gentlemen, you would certainly agree with.

Now I guess I will leave you a chance to respond, but be careful about giving this responsibility and authority away.

Mr. DEE. In considering this issue, we have contemplated the political volatility of the programs that are involved, and it appears to us, to our perhaps naive approach to political life, that one of the most fruitful avenues to pursue in trying to achieve this result would be a commission in which both parties have given their blessing and which would have the endorsement of the administration as well. Our approach is that simple; perhaps it's too simplistic.

Mr. SMITH. Well, I think Government does tend to overcomplicate things. And remember one thing about the Congress. We don't ever do anything until there's some kind of a crisis. In many ways, Gramm-Rudman is a self-created crisis to try and get this solution solved.

Let me go on. Mr. Morsani, you recommended base closures in the military spending and spending restraint. The administration has not put forth any base closures, and I think from among your membership——

The CHAIRMAN. Would the gentleman yield?

Mr. SMITH. Yes, sir.

The CHAIRMAN. In case the gentleman doesn't know, 2 years in a row, they have. Last year, they put forth 24 or 22; 5 of them were in my area. This year they came out with three, one in my area, and one in the Speaker's area.

Mr. SMITH. I stand corrected, but was given to understand that they were not in the budget itself. Is that right?

The CHAIRMAN. Oh, absolutely correct. The gentleman is correct. But I wanted to just inform him of this.

Mr. SMITH. I was just trying to get your attention, Mr. Chairman.

But the base closures, though, I think that if we were to spread the pain around, certainly you could poll your members and try and help us find a base in each State where that was possible. And I'm serious about that. I think that we need to be looking for things that are not militarily necessary for the defense of this country. So, I think that your members could help that, and I would urge that.

Mr. MORSANI. Well, of course, in that area of the military, too, we even think that as an example, you know—as I've said many times, in 1742 or whenever Leavenworth, KS started its first military base, they needed commissaries and health care facilities. I question that that's needed in any base in the United States today, and yet we don't address the problem.

Mr. SMITH. Well, I don't see any members from Kansas here, so you're probably safe with that statement.

But the Grace caucus did recommend about the——

Mr. FROST. Would the gentleman yield?

An outfit called AAFES, which you may be familiar with, the Army and Air Force Exchange Service, is headquartered in my district.

Mr. SMITH. Oh, sorry. We do have some political toes to step on.

I think the Defense Department should be urged to put down a list and to make changes. In this year, they might not make that much difference, but in the outyears, they will make a difference, and we need to get lean and mean, so to speak.

For all three of you, I have one question. Would you support a budget that met the $144 billion goal of Gramm-Rudman, but, in fact, took half from defense and half from nondefense? And I'd like to hear each of you respond. With no increase in taxation. I think your proviso is very correct.

Mr. KILPATRICK. I think the Roundtable would support any reasonable balance that achieves the goals of Gramm-Rudman. Whether that's exactly 50-50, I'm not sure. Defense is really the hardest thing for the business community to come to grips with, because there are confidential things about security that we simply don't know.

Mr. SMITH. Mr. Morsani.

Mr. MORSANI. I think that—we just—I think I have to take the same position that Bob has. We just don't know. I think we would be supportive of however we got there in the final analysis.

Mr. SMITH. Mr. Dee.

Mr. DEE. I don't pretend to be smart enough to know what the exact division ought to be between defense and nondefense. But it sure is clear to me that defense has got to pay its way here, just as well as nondefense.

Mr. SMITH. One last question. You people all manage fairly large corporations and have a lot of employees under your hire. What if I told you that at the end of 1980, the civilian employees in the Department of Defense numbered 990,000, and at the end of 1985, they numbered 1,129,000, an increase of some 138,000 civilians on the payroll at the Department of Defense, at an average cost of about $35,000 in now-year dollars, no outyear costs involved, that's about $5 billion total for any fiscal year? In my estimation, I think you could question, even with no knowledge of national security priorities, et cetera, whether that was, in fact, a good use of the defense dollar and whether it provided any more protection for this society.

Mr. KILPATRICK. I don't believe that I feel qualified to comment on that number.

Mr. MORSANI. I can't. I'm not qualified to say. I probably share your views that you question.

Mr. SMITH. OK. Well, I certainly question it.

Mr. DEE. I can't agree or disagree with the precise number. On the other hand, I know the direction in which you're heading, and it sure is important.

As I recall, both the Grace Commission and the CBO, both advocated within the Defense Department an executive department

concept, whereby there would be a civilian team right at the top, but that same civilian team would not be replicated in all of the various services.

It sounds to me just like common sense and a pretty good way to go, and I think that's the direction in which you're headed.

Mr. SMITH. Thank you.

The CHAIRMAN. Has the gentleman completed? We interrupted you twice. We want to be sure we gave you back the time.

The gentleman from Montana, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Gentlemen, when you say you are opposed to any increase in taxes, do you mean any increase in taxes on any specific corporation or on any specific income group, or do you mean you want tax reform that in the end is revenue neutral?

Mr. DEE. Well, the position that I advocated for the NAM is, no taxes at all. We believe that there are spending cut opportunities which offer the prospect of meeting the problem that is confronting us. As I tried to point out in my testimony, it is my own personal belief that tax increases on commerce are self-defeating, that in the long run they end up costing jobs, taking jobs away from the United States and giving them to competitors overseas. That's the wrong way to go.

Mr. WILLIAMS. There are members of the National Association of Manufacturers who pay taxes at the rate of 20 percent or more. There are other members, for example, the top four most profitable defense contractors in America, who in the last 4 years have had an effective tax rate at 1.5 percent.

I think your members who are paying the 20 percent would like to see a tax increase on those corporations that are paying at 1.5 percent or paying nothing, which is the great national scandal of today. I'm just trying to sort out whether you are for a reform that gathers taxes from those of your members who aren't even paying at a 5-percent tax rate.

Mr. DEE. Well, the companies that are paying at a rate of whatever, 1 or 5 percent or something, are not breaking the law. They are living according to the laws that have been set by Congress. If Congress, in its wisdom, feels that that is inappropriate, they need to alter those laws, change the circumstances that govern those tax payments.

Mr. MORSANI. I agree with Mr. Dee. I don't think there are any tax loopholes. I think it's incredible that people talk about tax loopholes.

There are tax incentives that this body put in place for good public policy in our country, sir, and if those need to be changed, then so be it. But it's not fair to say to people that there are tax loopholes; there are tax incentives.

Mr. WILLIAMS. I understand that. My point is, are you opposing those changes that would bring everyone up to a 6-, 8-, 10-, or even 12-percent effective rate?

Mr. MORSANI. What's going to be the game plan? I think what my colleague, Mr. Kilpatrick, said earlier, right now there is a conference committee going on that has a $140 billion tax hike in it for business, and we really should separate the deficit situation from the revenue side. I don't think we've done that effectively,

and I would hope we would do that. And then you can judge whether that has to be addressed, sir.

Mr. KILPATRICK. Mr. Williams, can I comment? Your question is a very good one here.

Our point at the Roundtable is that we believe that tax reform is diverting attention from the critical problem of the deficit in the House, the Senate, the administration, and the general public.

The business community that I represent is fully prepared to pay its part in both spending reductions and revenue increases, if it's part of a well thought out package. We don't see a package forthcoming. We see two separate parts progressing through the Congress, and that concerns us.

Mr. WILLIAMS. I guess I don't disagree with the statement made a few minutes ago that there's plenty of blame to go around with regard to today's problems. But I can't help but recall back not long after I first came to Congress, that either you gentlemen or your counterparts came before this Congress and did really a very good job of explaining yourselves and lobbying very, very hard for supply-side economics. There were certain promises inherent in supply-side economics, and you gentlemen and others sat at that table, pounded that table, and said, "It will happen."

One of the things that was going to happen was that we were going to increase personal savings. In fact, personal savings have plummeted.

We were going to get rid of the trade deficit. In fact, the trade deficit has gone through the roof.

GNP was going to grow, according to you and your experts back at your offices, at an unprecedented rate. In fact, while GNP grew postwar 3.5 percent with supply-side economics, it has yet to reach 3 percent.

Unemployment was going to plummet. In fact, after all these mechanics, after all of this supply-side economics, trickle-down, tax breaks, spending, loopholes, and all the rest of it, unemployment is almost back to where it was the day Jimmy Carter left office, although not quite.

You said that inflation was going to reach an all-time low. Well, it's improved, but it is still more than a point above what it was in postwar America.

You said interest rates would fall. Well, real interest rates are what count. All business people know that. And real interest rates are at an all-time record high in modern America.

I can go on. But in short, gentlemen, you led us astray. The country has never followed more closely the economic advice of one group than it followed your economic advice, and America's economy went in the dumpster.

Morning in America is great when you're running against Fritz Mondale and you can say everything in 30-second ads. But let me tell you, it's not morning in America. Small businessmen are going broke. Bank and small business failures are at an all-time high. This country has an enormous Federal and trade deficit, and in my judgment, it can all be placed at the feet of trickle-down economics which didn't work. It's tragic.

Mr. KILPATRICK. Let me make one response to that, Mr. Williams.

We have had unprecedented prosperity in this country in the last 4 or 5 years, and we shouldn't knock it.

Now second, my memory on what the business community was doing in the years I think you're talking about is slightly different, in the sense that we did advocate the 1981 tax cut strongly. There was also a spending reduction element that never was achieved. And I guess it's my way of saying that regardless of where all this comes from, we've had some pretty good years in an economic sense.

Now what we're saying today is, if we want to continue that, we'd better deal with today's problem. At the risk of being presumptuous, it isn't 1981 anymore.

The CHAIRMAN. The gentleman from Florida, Mr. MacKay.

Mr. MACKAY. Well, first, I very much appreciate your being here, and I appreciate the position you have taken.

Mr. Dee, what would be your response to the idea that instead of using any baseline as a starting point, that we just use last year's actual spending level? How would that——

Mr. DEE. I assume that you're talking about defense, in the defense arena?

Mr. MACKAY. Yes; everywhere.

Mr. DEE. Are you advocating the zero budget concept?

Mr. MACKAY. Just an outlay freeze based on the amount of money they were spending in the existing budget as a starting point. Just so we could all understand what we were doing.

Mr. DEE. In that there would be a freeze of all—in every respect across the board?

Mr. MACKAY. That's correct. With the possible exception that you would allow means-tested programs to be held harmless.

Mr. DEE. That idea has a lot of attraction, and my only concern with it would be that I would assume that it's perfectly possible, for example, in the area of defense that there are certain programs that are underway that, if you were to move in and would freeze them for the current year, the public would be paying a steep price as a result. There are too many things, too many elements in there that you just don't know, that we don't know, sir.

I would welcome any comments from my friends.

Mr. MORSANI. Well, I think, Mr. MacKay, if that scenario could be played out, that we would support that scenario.

Mr. KILPATRICK. I have nothing to add to that, Mr. MacKay.

Mr. MACKAY. Well, gentlemen, I very much respect your input. You head institutions which are themselves a major—you are the heads of major players in this. You have your own economists. Some would say that the private sector is able to hire economists who may be more state of the art than the public sector even, and your comments about unduly optimistic projections—that comment is very much on point, in my opinion, particularly since this year's projections go so dramatically differently than the projections that we were given as recently as 6 months ago.

I agree, the oil price increase is a serendipity that we ought to all thank God for, and I hope it will turn out to help us more than it hurts us. If it helps us more than it hurts our debtors, I guess it will be all right.

But the fact remains, we face a dramatic uncertainty that there's not a lot we can do about it. I mean, Secretary Baker was here this morning and said, "Look, those projections may be too conservative." We don't know yet.

This is a hypothetical. Assume that we make cuts in an aggregate amount equal to President Reagan's budget, maybe not in the same way, but assume we make that many cuts. What would you say to a contingent energy tax to go into effect only if the revenue projections fall short, so that we come up short on the revenue side of the deficit reduction effort?

Mr. MORSANI. I think the American people, Mr. Mackay—we have been paying for energy now for about 13 years. I really personally think they deserve a break.

Mr. MACKAY. I was trying to keep from offending you. What would you say to a corporate minimum tax?

Mr. MORSANI. I thought you were talking about the oil import tax.

Mr. MACKAY. That was not the point of the question. I'm sorry. I meant to say, what would you say with backing up the revenue side of the deficit reduction effort with a contingent tax?

Mr. MORSANI. If you talk about the corporate minimum tax——

Mr. MACKAY. Any one, the least objectionable one you can find.

Mr. MORSANI. We stated in fact last year that when we go through Treasury 1, 2, and 3, and I can't recall all the different ones that are currently on the table, if it was properly structured, we could probably support that position.

Mr. MACKAY. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from North Carolina, Mr. Hefner.

Mr. HEFNER. Thank you, Mr. Chairman.

In all due respect to you distinguished gentlemen, it appears that you, like others who have come before this committee, would be willing to delay tax reform and give up the Exim Program. I'm sure the committee will be glad to do this if it has been properly considered and determined to be in the best interest of the economy. I don't know what such a delay would cost us in the next year with the modifications that you suggest for investment tax credits and what have you.

However, I distinctly remember when we were trying to put together a budget in 1981 and there was a discussion on taxes. I also remember that the chamber installed in my district a phone bank which lobbied me to swallow the whole tax cut package on the basis of very rosy economic assumptions, and that it was very important we have a tax cut in 1981. I supported most of the things in that tax package.

I also remember—in considering that bill—the late day that Stockman said, the camels got their noses under the tent and the hogs began to feed at the trough and we went overboard.

A lot of the deficit that we have can be attributed directly, whether you wish to or not, to this tremendous deficit that we have.

In the last 5 years, if you had taken all the so-called giveaway programs, like AFDC, Food Stamps, Medicaid, SSI, programs that are so visible to people, and you had not spent one penny on these

so-called giveaway programs, we would still have accumulated $700 billion in new debt.

My question to you is, do you really believe, and I'm not going to do a Walter Mondale bit, the only thing that kept him from losing all 50 States, he didn't come out against dairy supports—I'm not going to go out and fall on a spear about revenues. I have yet to talk to an economist in your field, in your line of business—I have yet to talk to an economist that believes that we can get out from under these tremendous deficits without addressing revenues.

Do you believe, with the assumptions that we have in the President's budget and the assumptions that they are using, that we can grow ourselves out of these predicted $200 billion deficits?

Mr. DEE. If I may answer first, the spending levels, as I am sure you know, sir, are now at 25 percent of the gross national product, which is at an all-time high in the United States for a peacetime year since World War II; an all-time high. It is our thesis that it is the spending that is out of control, not the revenue segment that is out of control.

Mr. HEFNER. Let's look on the domestic side. In the last 5 years we have gone from 15.1 percent of GNP to 13.8 percent of the GNP. I am a strong supporter of national defense. I sat on the Defense Subcommittee. I am chairman of Military Construction, and incidentally, the administration's request is a 19-percent increase in military construction for this next budget cycle. Defense spending has gone from 5.3 percent of GNP to 6.4 percent. The interest on the debt has gone from 2.3 percent to 3.3 percent.

I talked to two of your members yesterday in Boston, who indicated that some of their leadership had supported a delay in the third year of the tax cut back some time ago. It seems to me that we have to address all of these areas. When you talk about defense, I know a little bit of what I speak about, but the President's budget is totally unrealistic because he is not using the baseline from whence we came. He is not using the numbers that we finally decided on. You are using the request numbers. You are about $15 billion off in that area.

Just as a last resort, is it completely out of the realm of comprehension that the National Association of Manufacturers, the Chamber of Commerce, and the Fortune 500 or whoever, would support deficit reduction if we made substantial cuts in spending, we held the line in defense, and we had reasonable growth, with all this package together, would you consider addressing some forms of revenues?

Mr. KILPATRICK. I would answer it this way, Mr. Hefner. In my testimony I said we recognize that revenue might have to be a part of a package as kind of a last resort, not to use that word. I think the key things would be spending must be restrained and we would look hard at defense. We asked you to do that. We asked you to look hard at Social Security, to see if we really need to have Social Security and COLA's and all that, for all of the population.

Let me take for example the chief executive officers in the Business Roundtable. It doesn't make any sense to guarantee all of full Social Security benefits and full COLA's. You ought to put a means test on Social Security at some point. You ought to cut spending. In other words, then show us a package that we believe has made a

really good-faith effort, particularly on entitlements and defense. I believe we would be supportive to a tax increase. We would argue about the form of it.

Mr. HEFNER. That is what I am saying. Don't put us in the position—you are like everybody else that comes in. If you will do so and so and so and so, then we will consider it. This is a bipartisan group. If the President is locked in and says by God, under no circumstances, over my dead body will you address revenues, or you are not going to touch Social Security and Tip O'Neill is saying, you are not going to touch Social Security, it puts us in an absolutely untenable position when the most powerful man in the world, the great communicator, has got his beak set in cement and has said, under no circumstance will we consider revenues, when we are hemorrhaging here, we are bleeding to death from these deficits.

You people are the ones who over the years have been the folks that have been decrying these tremendous deficits. Now I am hearing from some of the business community, well, it is not all that bad because it is only a certain percentage of the GNP. I tried to sell that for years, gentlemen, when we had Jimmy Carter in the White House, and it didn't work then and it's not working now.

What I would like is some commitment to say, look, we realize it is going to take a combination of growth, cuts in spending, and addressing revenues, whether it is through growth or what have you, not just setting your feet in concrete and saying under no circumstances will we consider revenues, because I think that is an intolerable position for this committee, for our Appropriations Committee.

In the last 26 years, Appropriations Committee has never appropriated more money than any administration asked for.

Mr. MORSANI. Mr. Hefner, we want to support that view and yet every time we get out on that limb, it gets cut off. We don't get the cut. We don't get the cuts in the expenses. As an example, just the current budget resolution targets in the last 5 years have been $24 billion more on average, but we don't see any discipline in the system. How can we turn around and support tax increases when there is no discipline in the very system we are trying to create?

The CHAIRMAN. Mr. Morsani, I would concur with that statement you just made about we don't see any discipline and we see a gap. Has your organization or do you have a view as to why that gap is there?

Mr. Hefner said something very important. Americans tend to forget because the President is a wonderful person, he is the most articulate person we have had since F.D.R., and probably he could beat F.D.R. on radio or television.

The reality is exactly what Mr. Hefner said. We have appropriated less than the President has asked for. He has submitted six budgets, including the one he just gave to us. Not one of them has been in balance or called for a balance in the near future.

Have you asked yourself, wait a minute, if they have appropriated less, why is it that every year we get a budget that is not balanced? You have had six opportunities by this President, starting in 1981, and we have not had one budget presented to us. There is no law that says he can't produce a balanced budget.

It is about time that we stop the game of running against each other. The White House says, not my fault, I haven't been the President of the United States all these years, it is Congress. We sit over here and say, It is the Senate and the Senate says its the House. The Democrats say it is the Republicans. The Republicans say it is the Democrats.

When do we say, Mr. President, you are the President. You are the most popular President we have had. You have submitted six budgets and not one of them has projected a balance in 3 years.

Second, when you look at the total appropriations during that 5-year period, Congress has given you less money, not more, less money than you asked for in those budgets.

You say there is a gap. You are absolutely right. What is the cause of the gap? I guess that is what I am not hearing.

The gentleman's time has expired. I know Mr. Morsani has to catch a plane. I think Mr. Kilpatrick has to leave. You have 2 minutes. I promise to let you out of here at 3:30.

I would like to just show you gentlemen something, so that we can understand. I would like for you to just take a look at something. This is 1981 [indicating]. These are the priorities of the Nation in 1981—23 percent on defense; 40 percent on discretionary and other entitlements; 26 percent on Social Security and Medicare; 10 percent on net interest.

Forget how you feel about defense and Social Security; forget that. Here we are today—28 percent on defense; 28 percent on entitlements; 28 percent on Social Security; 15 percent on net interest. In other words, the discretionary domestic programs went from 40 to 28. Defense went from 23 to 28. Social Security and Medicare adjusted for democratics—demographics. [Laughter.]

Mr. SMITH. Mr. Chairman, can we let the record show——

The CHAIRMAN. That was a Freudian slip; 20 percent; the net interest, 10 to 15 percent. If you just add that up, and forget how you feel about the choices here. That is not the issue. I am not arguing strong defense versus welfare. That is not the argument.

If you take 5 percent there, take 2 percent there, 5 percent there, you have the same spending patterns, just readjusted, reshuffled; that's all. That is why spending has not gone down. Spending is at the highest rate it has ever been as a ratio of GNP.

It seems to me, gentlemen, and not the three of you—in 1981, you were not sitting, Bob Dee, as chairman of NAM, and Frank Morsani, as Chamber of Commerce head, and Bob Kilpatrick, as the Business Roundtable head. But I can remember in 1981, your predecessors urging the adoption of a particular fiscal policy. It was inculcated in Gramm-Latta I and II. We did that. The President got 98 percent of what he wanted in 1981; 97 percent in 1982. We even put back $100 billion of the revenue base through TEFRA, which the President supported. We even made up some revenues vis-a-vis Social Security in the 1983 compromise, all totaling about $200 billion in revenues.

Yet, we still had the problem, despite these facts. It just seems to me, gentlemen, that if you argue to follow the line of the President's budget, you are really arguing to continue the hope which has not borne out in 5 years. It was that fiscal policy, monetary policy, would lead eventually to a balance. Forget the choices,

whether you want 12 percent growth in defense or whether you want to get rid of Exim. I am not talking about choices now. I am talking about fiscal and monetary policy.

It seems to me if you follow that line, you are not going to dry up the red ink. You are going to basically allow the red ink to stay. Despite the fact that I know each of your organizations supported Gramm-Rudman, reality is I haven't met anyone yet except a few people who believe that from 1983 to 1991, we are going to have uninterrupted, positive growth. This is the basic economic assumption of Gramm-Rudman and what has been part of the problem, Mr. Morsani, in answer to your question, as to why we had deficit projections and every time we reached for it, we missed it.

How can you when you predict 4 percent growth and even OMB and CBO come out and says, oops, we have 2.5 percent? That is a $20 billion bulge right there. Then you get a budget that is presented to us as has been acknowledged by Senator Domenici, by CBO, and other econometric organizations, that in just defense alone, is $15 billion off target. God knows what it might be on the domestic side, agriculture, et cetera.

We are being told that hits Gramm-Rudman? I submit to you, gentlemen, that the President is right. We need to reduce the deficit. I would submit to you that his budget is not going to bring you one iota closer to it than his other five budgets did. You have to pay for that Navy. You don't get it from Goodwill Industries. You have to pay for those F-16's. You don't get it from the Salvation Army.

Mr. Morsani, would you say to a person in your company, who said, Boss, I have a new idea for running this division. Here is what it is; I'm going to cut back on sales, I am going to invest in capitalization, new plant, new equipment, major expansion, don't worry, things are going to balance out. You say, All right, fine. A year goes by—you are losing money. The second year goes by—you are losing money. The third year goes by—you are losing money. The fourth year goes by—you are losing money. The fifth year goes by—you are still losing money.

My point gentlemen, is you would not allow those very same kinds of standards to apply to your own businesses and industries. You would tell that vice president in charge of that division, bye.

I am submitting to you that I think we still have a major problem as we look at the budget that is before us.

Mr. Smith.

Mr. SMITH. You are forgetting about what the prime rate and the unemployment and some of the other things were in January 1981. I think certainly your view is to be considered, but you don't want to consider the other factors in the economic pie we are talking about.

The CHAIRMAN. I haven't forgotten what the prime rate was then or what the real interest rate is today. Yes, we have come down from 19 or 18 percent to 11 percent. Real interest rates are still inordinately high, which therefore prevents the National Association of Manufacturers from getting the kind of capitalization they need for expansion and investment and infrastructure.

Bill Gramm is a little bit better if I am going to buy my house or a car, but we are not talking about that. We are talking about

really providing for the fueling of long-term investment productivity and economic growth in the country.

Mr. SMITH. No doubt about the fact that if we had more Government out of it, we would be in better shape.

The CHAIRMAN. I would simply say in conclusion, I want to thank all three of you gentlemen for giving us your views. You have been quite candid, quite straightforward. They will be taken into consideration. We hope that this year, as we put together our budget resolution, we might be able to get it done bipartisanly, and might be worthy of the kind of support your organizations can give to the process.

Last year we did make a big start. We want to keep that progress going.

Mr. DEE. We thank you, Mr. Chairman. God bless you and may he give you inspiration.

The CHAIRMAN. How about strength? Buddy MacKay, did you have one parting comment?

Mr. MACKAY. I just wanted to say that in comparing these groups' participation this year, I think this is a major constructive step. You are basically saying we are willing to come and look ahead, forget about what has happened thus far, and we are willing and anxious to be participants. I think it is very constructive and I appreciate it.

The CHAIRMAN. Gentlemen, thank you and your staffs. We look forward to working with you through the rest of the process.

[Whereupon, at 3:38 p.m., the committee adjourned until Thursday, February 20, 1986.]

IMPACT OF THE PRESIDENT'S 1987 BUDGET

THURSDAY, FEBRUARY 20, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The CHAIRMAN. The Budget Committee will now come to order.

Mr. Secretary, I want to congratulate you on your appointment as Secretary of the Department of Health and Human Services and welcome you before this committee. The Department of Health and Human Services which you administer, includes the core of the social welfare system, which has evolved in the United States over the past half century.

This places you in the vortex of the dispute about how the social system should evolve and what reductions, if any, should be made to social and domestic programs, as we seek to bring the Federal budget into balance.

Earlier this week we heard from OMB Director Miller about the composition of the President's deficit reductions proposal. As a physician yourself, you administer the department with the largest medical assistance programs. If the President's budget is adopted, you would oversee outlay reductions of $5.6 billion next year just in Medicare and Medicaid. The budget again proposes that the elderly and disabled Medicare beneficiaries pay higher out-of-pocket charges. Again, the budget calls for drastic cuts in Medicare support, for medical education, a reduction which could threaten health care services in some of our inner cities.

Overall reimbursement, the health care providers is proposed to lag behind the increase in health care costs. In Medicaid, the budget again proposes to change the nature of the program from an open-ended entitlement to a program in which the Federal contribution is kept.

According to charts which Mr. Miller used in his testimony, these health care savings represent one-fifth of the domestic program savings requested by the President.

This committee would like to know if these savings can be achieved without jeopardizing the provision of quality medical care to the aged as well as to the poor in our great Nation. Your Department also administers some of the core programs which provide assistance to families in difficulty, such as public assistance.

Earlier this month, in his State of the Union Message, the President said "Family and community remain the moral core of our so-

ciety. Guardians of our values and hopes for our future." Most of us would agree with the President in that statement which he articulated so well, yet the President's budget proposes major reductions in public assistance. This includes $1.3 billion in funding below the CBO baseline from benefit cuts which Congress has repeatedly rejected and from fiscal sanctions which could force States to reduce benefits.

The committee wants to know how these and other budget proposals which affect families will help families "remain the moral core of our society."

As we look at the President's budget as it impacts upon those areas in your jurisdiction, there are many of us who have concerns that instead of strengthening the family, it actually weakens the American family.

There are many issues that we must address in this hearing and we hope that your appearance today will provide us with background information that justifies the choices and the priorities made by the President in his fiscal year 1987 budget.

Mr. Secretary, we welcome you to the House Budget Committee. We again congratulate you on your appointment. We look forward to working closely with you as we shape the priorities of this Nation, as we reduce our deficits, while at the same time, maintain our sense of compassion and equity for all citizens in our society.

Mr. Secretary, we would ask you to summarize your testimony. Your entire testimony will be submitted for the record. Therefore, if you would like to highlight the major points, we certainly welcome that.

Again, welcome, Mr. Secretary. Feel free to proceed.

STATEMENT OF HON. OTIS R. BOWEN, SECRETARY OF HEALTH AND HUMAN SERVICES, ACCOMPANIED BY HENRY DESMARAIS, ACTING ADMINISTRATOR, HEALTH CARE FINANCING ADMINISTRATION; ROBERT HELMS, ACTING ASSISTANT SECRETARY FOR PLANNING AND EVALUATION; AND JOANN ROSS, ASSOCIATE COMMISSIONER FOR FAMILY ASSISTANCE, SOCIAL SECURITY ADMINISTRATION

Mr. BOWEN. Thank you very much, Mr. Chairman. I do thank you for your invitation to be here today. I believe I have submitted my more detailed and longer printed statement for the record. I want to share a few brief remarks before taking your questions.

This is something of an anniversary. It was exactly 60 days ago that I took my oath of office. I was aware of the responsibility. I was also aware of the challenge.

As a former State legislator and Governor, I appreciate the problems with which both the legislative and executive branches must cope. They are best solved in the spirit of mutual respect and understanding. It is in that spirit, Mr. Chairman, that I come here today.

We know of the need to reduce the deficit and balance the budget. We also know the need to ensure that the HHS constituencies are properly served. In fashioning our 1987 budget proposals, this was foremost in our minds. Our proposed budget for fiscal year

1987 totals $345.6 billion. This is $12.7 billion more than our 1986 budget and $30 billion more than the HHS budget for 1985.

Since 1981, the Department's budget has increased by $118.8 billion. To me, the numbers with which we deal are astronomical. They become even more so in consideration of two facts. Our 1987 proposals totaled 34.8 percent of the total Federal budget. This compares to 29.5 percent for the Department of Defense.

In fashioning our 1987 budget, our priorities were balancing the budget by 1991 with no tax increase; containing health care costs and maintaining quality of care; meeting our commitments to older Americans, the disabled and other truly less advantaged; and enhancing self-sufficiency by properly supporting the family as a vital nucleus of our society.

Included in these priorities are Social Security COLA's. For January 1987, the estimated increase is 3.7 percent. Meanwhile, OASDI trust fund solvency has been assured into the next century. The funds borrowed from the Medicare trust fund have been repaid 2 years earlier than anticipated. The Medicare trust fund has achieved the point of safety for the remainder of the current century.

Two years ago, double-digit inflation in health care costs threaten to price that care out of the reach of many who needed it. We have come a long way in correcting that condition. Much more needs to be done if health care cost is to be reduced to the necessary parity with the general inflation rate.

In response to that need, our 1987 proposals include a series of major regulatory and legislative changes to hold Medicare and Medicaid outlays in check without compromising the quality of care. These Medicare proposals will save $4.7 billion in 1987 and $54.5 billion over the next 5 years.

Specifically, these proposals would phase hospital capital cost reimbursement completely into prospective payment over the next 4 years. It would eliminate classroom overhead and allied training as reimbursable expenses for direct medical education. It would eliminate windfall doubling of indirect medical education payments.

It would increase part B premiums for individual payers to 35 percent of the program cost by 1991. It would increase part B premiums for third party payers to 50 percent in 1987. It would increase the part B deductible from $75 to $100 in 1987. It would index the part B deductible to the Medicare economic index in calendar year 1988.

It would extend Medicare as a secondary payer to all working people over age 69 and disabled spouses who are covered by employer based health insurance, and it would eliminate excessive reimbursement of physicians for certain procedures and correct the index used to computer physician payments. A detailed explanation of these proposals reside in my formal statement.

Our 1987 proposals would limit Federal Medicaid payments to $23.6 billion. This would be $1 billion below the current estimate for fiscal year 1987. Each State's share for 1987 would be limited to a reasonable and fair increase over its 1985 expenditures plus any amount that a State might receive from a special one-time-only hardship fund.

For 1988 and beyond, fiscal year 1987 spending limits would be indexed to the Medicare component of the Consumer Price Index. This hardship fund is intended to help ease the transition. It will be made available to States encountering hardship despite bona fide cost control efforts. To help States control their Medicaid spending, we will be proposing increased program flexibility. The objective will be to ensure more effective care delivery at lower cost.

In conjunction with the limitation on Federal payments, we will be proposing legislation that will allow States to target needed services to vulnerable groups where they would have the greatest payoff in preventing and resolving special health problems.

It would revise eligibility rules so that States may better account for the income and resources of the recipients. We would better manage the health care recipients by increasing services and reducing overutilization. We would make better use of prepaid health plans such as HMO's by reducing the fiscal risk that health plans face in enrolling Medicaid recipients. They would operate their Medicaid computer systems and medical review programs without burdensome Federal paperwork requirements and penalties.

Other related measures include legislation the administration introduced recently to help States verify third party health insurance coverage to their Medicaid recipients, thus avoiding Medicaid costs. The administration has also proposed AFDC job search, work experience and on-the-job training legislation that will help States reduce Medicaid costs.

In addition to these 1987 proposals, the President has called for an examination on how the private sector and Government can work together to address the problems of affordable insurance for those whose life savings would otherwise be threatened when catastrophic illness strikes.

We are enthusiastic about the President's charge to examine the entire question of catastrophic illness costs, including possible actions for both the private and public sectors.

Our 1987 requests for the National Institutes of Health would establish a stable level of research grants. This level would be sustainable in future years whenever greater deficit reduction targets would have to be met. Our total 1987 NIH request is $4.9 billion. This will support 18,000 research project grants and 523 research centers.

For the Alcohol, Drug Abuse and Mental Health Administration, our 1987 request will support 1,400 research project grants. Our 1987 request would also permit us to maintain efforts to prevent and control disease and enforce food, drug, and medical device laws.

As the President has emphasized, AIDS remains the highest public health priority of our Department. Under this priority, he has offered a Surgeon General's report on the problem. We have requested $213 million for AIDS research and education.

The major programs for the Food and Drug Administration and the Centers for Disease Control will be restored to their 1985 levels.

To further assist AFDC recipients, our 1987 proposals include work opportunity incentives. For this new program, employable AFDC recipients would be directed into activities which would help

them find and maintain employment. These activities would include job search, community work experience and on-the-job training.

Our 1987 proposals also seek an additional increase of $56 million over the revised 1986 level for the foster care and adoption assistance programs. We plan to restore other high priority family related programs to their 1985 funding levels. These include Head Start and nutrition programs and other services for older Americans. Those who need our services must be served. They are being served under our 1986 budget and they will be served under that for 1987.

Of the myriad of problems with which our Department must deal, Mr. Chairman, none concerns me more gravely than the status of the American family. The epidemic of teenage pregnancy, rampant drug use and the violence it spawns in our streets, homes and schools, are results of dissolution of the family unit. The consequences strike hardest at the black family. Until a generation ago, the vast majority of all children lived in two-parent families. Today, over half of all teenage births are out of wedlock. Often they are born to mothers who themselves are still children. Young boys and girls must be brought to realize that teenage parenthood is a one way ticket to voluntary poverty.

We have no choice but to address this frightening condition. It tears deeply at our national fabric. The problem does not begin with Government, nor is it Government's sole domain.

In fact, quite the contrary. Increasingly over the past 20 years, Government has sought to do what should have been done in the home in the first instance. I would not question the good intentions. Intentions notwithstanding, however, we now live with the results. As many of us believe, we now must take a hard look at the empirical evidence of what has been wrought. We now must study the need to reform our thinking and change our efforts.

The President's study of our social welfare system is such an effort. It should be appreciated, however, that Government programs are no substitute for morality and the values it fosters.

Government itself is no substitute for a mother, a father, and stable, loving home life.

As you know, Mr. Chairman, I am a physician, and as a private practitioner, my primary concern has forever been the health and welfare of my patients. In my new position, that concern is extended to all who need the services of my Department. In one form or the other, those services touch the lives of every one of our fellow citizens.

If I thought for 1 minute that our budgetary proposals failed to meet that responsibility of service, I would not have accepted appointment as Secretary of Health and Human Services.

Mr. Chairman, that concludes my oral statement, and I shall be pleased to try to respond to questions. If I do not have a ready answer to every question, be assured that I shall be pleased to see that one is provided, either in writing or by some of my very highly qualified assistants who sit behind me.

[Testimony resumes on p. 364.]

[The prepared statement of Mr. Bowen follows:]

PREPARED STATEMENT OF HON. OTIS R. BOWEN

Mr. Chairman and Members of the Committee:

I am here today to present to you the fiscal year 1987 budget for the Department of Health and Human Services.

The priorities for health and human services we have embodied in this budget are based on two important assumptions: that spending must be tightly controlled to meet deficit reduction targets agreed upon by both the President and the Congress; and that essential benefits for the Nation's most vulnerable individuals and families -- the poor, the elderly, the disabled -- must be maintained.

Reducing the Federal deficit is the most important domestic problem now facing us. The FY 1987 budget and legislative program for the Department present a balanced plan that restrains growth in spending as an integral part of the Administration's goal of meeting the deficit targets established by the Balanced Budget and Emergency Deficit Control Act of 1985. We are acting decisively now to preserve the gains we have made under the current economic recovery. As you know, the President's budget would reduce this deficit by $38.2 billion below the current services level of spending. My Department's share of that reduction is $7.8 billion, which is 2.2 percent below the current services level for HHS.

In making these decisions, we have been careful to meet our commitments to older Americans, the disabled, and other truly less advantaged and to support the family as the vital nucleus of our society.

To meet these commitments, HHS will spend a total of $345.6 billion in 1987, an increase of 3.8 percent over 1986. The following provides an overview of this budget by function.

EDUCATION, TRAINING, EMPLOYMENT AND SOCIAL SERVICES

(Function 500)

The HHS budget includes budget authority of $5.5 billion under function 500, primarily for the social services activities of the Office of Human Development Services (OHDS).

In this budget, we have continued the policies of this Administration to support social services and related programs which promote self-sufficiency among program recipients, while focusing Federal resources on the most effective and efficient programs. In brief, the OHDS and OCS budgets will: consolidate existing child abuse and family violence categorical programs into a new Family Crisis and Protective Services program; increase funding for Foster Care and Adoption Assistance; reduce funds in selected research, training, and discretionary areas;

and eliminate funding for the Community Services Block Grant and the Work Incentives programs (WIN). To replace the WIN program, the Administration is proposing a work opportunities program which would strengthen work requirements for AFDC recipients, while allowing States flexibility in designing work activities.

BLOCK GRANTS

The 1987 budget request provides for the Social Services Block Grant at the full authorization level of $2.7 billion. No funding is requested for the Community Services Block Grant (CSBG), which duplicates other existing Federal program authorizations. States may use other sources of funding, including the Social Services Block Grant, to support those community services activities which are of the highest priority and most effective. Elimination of the Community Services Block Grant will affect only 12 percent of Community Action Agency funds. Community action agencies will continue to receive approximately 86 percent of their funding from Federal program authorizations for which funds have been requested for 1987.

HEAD START

A total of $1,075 million is requested for the Head Start program, which provides comprehensive support services and early childhood development for poor and handicapped children up to age 5. This level will support services to 448,250 children, the same number as in 1986. Of the total enrollment, at least 10 percent will be handicapped.

AGING PROGRAMS

The 1987 budget includes a total of $689 million for Aging programs. Within this total, $669 million is requested for Title III activities (the same level as provided in 1985 and an increase of $29 million over 1986) which include supportive services and centers and the nutrition programs of congregate and home-delivered meals.

DEVELOPMENTAL DISABILITIES

A total of $73 million is requested for activities to develop and expand services for persons with developmental disabilities. In 1987, these funds will provide continued support for the Administration's effort to increase private sector employment opportunities for developmentally disabled individuals.

FAMILY SOCIAL SERVICES

The 1987 budget requests a total of $818 million for these programs with a purpose of keeping families together or supporting other appropriate living arrangements when reunification of children and families is not possible. As part of the Administration's effort to reduce the deficit, the request continues support for legislation introduced as part of the 1986 budget which is estimated to save $39 million in 1987 by: removing barriers to Medicaid coverage for children with special needs adopted under the Adoption Assistance program; modifying requirements for Foster Care financing; and creating incentives

for States to reduce the duration of children's stays in Foster Care services. The budget request includes $544 million for Foster Care, $200 million for Child Welfare Services, $4 million for Child Welfare Training, $60 million for Adoption Assistance, and a total of $10 million for Child Welfare Research and Demonstrations, Social Services Research, and Adoption Opportunities activities. In addition, a 1986 supplemental request is proposed for later transmittal to provide $93 million for Foster Care prior-year claims and $7 million for Adoption Assistance prior-year claims and additional program costs.

WORK INCENTIVES

In 1987, no funds are requested for the Work Incentives (WIN) program because, as studies by the General Accounting Office and others have demonstrated, this program has not been effective in providing training or work experience to participants. Instead, the budget continues to support legislation introduced last year which requires job search and work activities for AFDC recipients, while giving States flexibility in the design of their specific work programs. This flexibility would allow States to maintain or further develop innovative work alternatives now funded with WIN monies, such as those in place in California and Massachusetts.

FAMILY CRISIS AND PROTECTIVE SERVICES

The 1987 budget proposes legislation to consolidate several narrowly-constructed categorical programs into a program of Family Crisis and Protective Services Grants for States. We are requesting $31 million for this new program. This proposal will give States greater flexibility in addressing the related issues of child abuse and family violence.

HEALTH

(Function 550)

The Department's Medicaid and discretionary health programs are included in this function. The budget includes outlays of $33.9 billion for these programs in 1987.

MEDICAID

The 1987 budget for Medicaid is $24.7 billion. Approximately 23.6 million needy individuals will be served by the Medicaid program in 1987, 2 million more people than in 1980.

The provisions of the Omnibus Budget Reconciliation Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 played a major role in providing States with the incentive and flexibility to moderate growth in Medicaid expenditures in recent years. Home and community-based service waivers, freedom-of-choice waivers, and flexibility in hospital reimbursement

systems have all helped States to deliver care more efficiently and at lower cost. The 1987 budget continues these efforts to stem the rate of growth in the Medicaid program and to provide States with an incentive to adopt new methods of managing their programs in a cost-effective manner. These proposals include:

Limitation on Medical Assistance Payments

We are proposing legislation to limit Federal Medicaid expenditures for Medical Assistance Payments to $23.6 billion. This limit represents a $1.3 billion reduction in Federal payments below current spending projections for 1987, and is needed to continue control of program costs.

Federal spending increases in future years would be limited to inflationary adjustments as measured by the Medical Care Component of the Consumer Price Index.

We are also proposing a separate one-time $300 million "hardship" fund in 1987 for States which have taken aggressive measures to control costs, have complied with Federal requirements, and still have costs over their limit.

A number of measures will be proposed to assist States in meeting the ceiling imposed on Federal Medicaid expenditures in 1987. Regulatory initiatives with respect to second surgical opinion, prescription drug reimbursement, and expanded third-party liability will assist States in absorbing the funding

reduction. In addition, the Department is working on legislative changes which would enhance State flexibility in operating their Medicaid programs under the reasonable growth limits.

Elimination of State Administration Special Matching Rates

The Administration is also proposing to eliminate all special matching rates for State and local Medicaid administrative costs and to reduce matching for excessively high administrative costs. This proposal would eliminate special subsidies which have outlived their purpose and would also provide incentives for States with high administrative costs to achieve efficiencies. This proposal would save $260 million in 1987. Related proposals will also be advanced for the AFDC, child support enforcement, and food stamp programs.

DISCRETIONARY HEALTH PROGRAMS

For the discretionary health programs of the Public Health Service (PHS) in 1987, we are requesting $9.0 billion in budget authority and $9.1 billion in outlays. These funds will be used to help Americans achieve improved health status by supporting biomedical research, conducting disease investigations, implementing health promotion practices, and assisting States to deliver health services.

Health Research

The 1987 budget includes $4.9 billion for the National Institutes of Health (NIH) and $337 million for the Alcohol,

Drug Abuse and Mental Health Administration (ADAMHA) which will continue support for basic biomedical and behavioral research that will be translated into future long-term improvements in medical care and the health of the American people.

In 1987, 18,000 total research project grants will be supported by NIH. The budget request is sufficient to provide an estimated 2 percent increase in direct costs for research project grants. Payments for the allocated overhead portion of indirect costs to research grantees will be reduced by $85 million through a cap on the administrative components.

Increased fiscal pressures throughout the Federal budget demand that a level of stability be achieved in project grants that will not result in large fluctuations of resources for other research support mechanisms. In addition to the stability policy for managing resources, both NIH and ADAMHA will devote greater cost consciousness in the review and funding of project proposals. The stability level for ADAMHA is 1,400 research project grants.

Research will continue to be pursued during this period of rapid advancements in the life sciences in such priority areas as Alzheimer's disease, molecular genetics, immune system research, schizophrenia and depression, and development of therapeutic agents and a vaccine for AIDS.

Health Promotion and Disease Prevention

The 1987 budget generally maintains expenditures for health promotion and disease prevention in order to reduce the spread of disease, encourage healthy life styles, and help control health care costs. For our two principal prevention organizations, the budget requests $380 million for the Centers for Disease Control (CDC) and $424 million for the Food and Drug Administration (FDA).

Within the request, funds are included to continue the record high immunization levels of over 95 percent achieved for school-aged children. No funding is requested in 1987 for the vaccine stockpile. Through 1986, an average 16-week emergency reserve supply of all major childhood vaccines will have been accumulated in case of a stoppage in domestic production. The Administration has transmitted to Congress legislation to eliminate punitive and limit non-economic damage awards against vaccine manufacturers to help ensure that these companies can obtain liability insurance, the major factor responsible for the temporary diptheria-tetanus pertussis vaccine shortage of a year ago.

Over the past four years, this Department has supported a major research effort on Acquired Immune Deficiency Syndrome (AIDS) to determine its cause and control its impact in the population, to develop the means for preventing this disease,

and to improve the diagnosis and treatment for AIDS. In order to highlight, plan, and coordinate the total level of resources devoted to this top public health priority, the budget consolidates expenditures for AIDS activities. Funds are also included in the Department of Agriculture appropriations bill which contains the Food and Drug Administration's budget request. However, operational responsibility will continue to reside in the individual agencies involved. The budget authorizes allocation of AIDS funds among PHS agencies as scientific breakthroughs occur and new opportunities are identified. The Assistant Secretary for Health recently appointed an AIDS coordinator to monitor projects, identify gaps in activities, and make decisions that keep these efforts on track.

I am pleased to report that the rate of increase of this dreaded disease has begun to decline slightly. Over 16,500 cases in the U.S. have been reported to the Centers for Disease Control since 1981. Extraordinary progress has been made in a relatively short time in understanding this new and devastating disease, including identification of the causative HTLV-III virus; enhancing the protection of the blood supply and hemophiliacs; initiation of clinical studies of promising therapeutic drugs; and the development of public health guidelines for health care workers, schools, and blood collection centers. To continue this effort, $213 million is requested in 1987 to combat AIDS. This will bring the total level of resources expended on AIDS since 1983 to $485 million.

Health Professions Education

In view of steadily increasing supplies of physicians and nurses, projected national surpluses in these occupational fields, and the improved distribution of health care practitioners to medically underserved areas, no funds are requested in 1987 for the Health Professions education grants. These Federal subsidies were initiated 20 years ago to alleviate personnel shortages existing at that time. We have successfully accomplished this goal, and the time has come to phase out Federal support of these programs.

The Health Education Assistance Loan Program (HEAL) will provide $100 million of new guarantees for private loans to graduate students in health professions schools. Work is progressing to ensure the long-term solvency of the loan insurance fund. Borrowers will be required to pay an 8 percent insurance premium; lenders will share in 20 percent of the loan liability. Borrowers will also be required to purchase credit life insurance.

Health Block Grants

A total of $1.6 billion is included in the 1987 budget for the four health block grants. This includes $565 million for several programs (Community Health Centers, Black Lung Clinics, Family Planning, and Migrant Health) which we are proposing to

consolidate into an expanded Primary Care block grant. This consolidation will allow the States maximum flexibility to target resources and respond to their specific primary health care needs in a more comprehensive manner.

As recent studies have shown, block grants have functioned well, with States establishing their own priorities and exercising their increased decision-making authority. In addition, States have increased their own financial contributions to these programs, particularly in the health areas. We find this a positive indicator that States are willing to spend more of their own funds when they have a greater say in how these funds are being utilized.

MEDICARE

(Function 570)

The 1987 budget for the Medicare program is $70.2 billion, an increase of $1.6 billion or nearly 2.3 percent above the 1986 current estimate.

Spending for Medicare represents 20 percent of the entire HHS budget and 7 percent of the total Federal budget. Approximately 32.3 million of the Nation's elderly and disabled will have their health care needs met through the Medicare program in 1987, 4 million more people than in 1980.

During the recent past, a number of changes have occurred in Medicare. The most notable improvement is, of course, the new prospective payment system (PPS) for hospitals initiated by this Administration and approved by the Congress in 1983. All acute-care hospitals are now under this system, except those specifically exempted by law. This system has been a major factor in the recent slowing in the rate of increase in Medicare expenditures.

Although health care inflation has declined in the past few years, these costs are still growing at almost twice the rate of general inflation. This rise in health care costs has been the major cause of excessive growth rates in Medicare. Expenditures have grown from $7 billion in 1970 to $32 billion in 1980, and have more than doubled since then. By 1991, without the reforms included in this budget, Medicare outlays will reach $115.4 billion.

The budget includes a number of legislative and regulatory proposals designed to slow the rate of growth in program expenditures, while continuing to meet the health care needs of the elderly and disabled.

In general, the 1987 budget for the Medicare program proposes to incorporate hospital capital payments into the Prospective Payment System, revise graduate medical education payments, and restrain increases in physician and other provider reimbursement while continuing to encourage competition in the health care sector. In total, these proposals will reduce Medicare expenditures by $4.0 billion in 1987 and by $37.3 billion over the next five years. In addition, general fund subsidies to the Medicare trust funds will be reduced by $0.7 billion in 1987 and by $17.2 billion through 1991 due to restoring the Part B premium closer to the initially intended levels.

Establish Prospective Payment Policy for Reimbursement of Hospital Capital Costs

This proposal would gradually incorporate payment for hospital capital costs into the Medicare prospective payment system over the next four years.

The Social Security Amendments of 1983, which created PPS for hospital operating costs, also provided for capital costs to be included in the definition of costs covered by PPS starting October 1, 1986. Hospital capital costs are now being reimbursed on a cost basis -- a system proven to be inflationary and inefficient. In fact, captial costs are currently increasing at double-digit rates annually, many times the rate of general inflation.

In order to permit hospitals time to adapt to the revised payment system, the proposal would be phased-in over four years. When this new system is fully implemented, a fixed payment that includes both capital and operating costs would be made for each Medicare admission. This proposal will enhance the positive incentives for hospital efficiency and cost effectiveness demonstrated by PPS. We expect to realize savings of $456 million in 1987 and $11.5 billion over the next five years.

Limit on Reimbursements for Graduate Medical Education

Several reform measures in the medical education area will be undertaken to insure that payments are made for services and that payments are reasonable.

Medicare has traditionally reimbursed hospitals for the costs associated with graduate medical education programs. The direct costs, such as resident salaries and education expenses of residents, allied health professionals, and nurses, are reimbursed on a reasonable cost basis. Regulatory changes will be made to eliminate payments for education subsidies while retaining reasonable payments for services. Consistent with efforts to set reasonable limits on Medicare payments, hospital-specific limits on interns and residents' salaries will be established.

The statute requires payment for the services of residents and interns, but does not require payment of education expenses, or allied health training, which do not directly benefit patients, and thus, they will be eliminated. Dramatic gains have occurred in the availability of medical personnel since the shortages in the 1970's.

Medicare also reimburses hospitals for the indirect costs associated with teaching programs. These costs are due to a variety of factors, such as the ordering of additional tests by interns and residents. Prior to PPS, Medicare payment for these costs was based on an adjustment factor which estimated how a hospital's cost increased as the number of interns and residents increased. The Social Security Amendments of 1983 doubled this adjustment factor without any empirical justification, and this has resulted in windfall payments to teaching hospitals. This proposal would eliminate the doubling of the indirect medical education cost payment. In addition, the payment formula will be revised to reflect that Medicare per resident costs increase at a slower rate as hospitals' teaching programs become larger.

Together, these proposals will save $1.6 billion in 1987 and $12.2 billion between 1987 and 1991.

Selective Physician Reimbursement Reform

Although the rate of increase of physician payment spending has slowed, total payments to physicians continues to be one of the fastest growing parts of the Federal budget, increasing at double-digit rates. This budget reflects a number of reforms which correct selected overpayments and will save $432 million in FY 1987.

Medicare FY 1987 physican payments are projected to increase $2.1 billion above 1986 levels and at an average annual rate of 12 percent over the next five years. This rate of growth is significant, given the physician fee freeze which began July 1, 1984 and expires on March 15, 1986. To slow this rate, we intend to initiate the following actions:

-- Adjust the Medicare physician payment inflation factor (the Medicare Economic Index (MEI)) to correct for the historical overstatement of housing costs. (A similar change was made to the Bureau of Labor Statistics' calculation of the CPI);

-- Control payments to physicians for specific procedures that are overpriced because of technological or productivity advances, or geographic variations;

-- Reduce excessive payments for lens replacements after cataract surgery and adopt stricter criteria to ensure the medical necessity of lens replacements; and

-- Limit payments to physicians who provide standby anesthesia services, and limit payments for unnecessary assistants at surgery.

Update End-Stage Renal Dialysis Rates

Medicare currently makes a facility and physician payment under the End-Stage Renal Dialysis (ESRD) program for routine dialysis performed on an outpatient basis. Since 1983, payment for outpatient dialysis has been on a prospective basis. For routine dialysis, the supervising physician receives a monthly capitation rate and the facility receives a per treatment facility fee.

We propose to update ESRD rates using the most recent data available. Facility rates will fall as a result of more appropriate weighting of treatment and facility mix in rate computations. In addition, recent data from a General Accounting Office study on the average number of visits provided by physicians for home dialysis patients will be used to revise the monthly capitated rates paid to physicians for ESRD-related services. This proposal will result in savings of $90 million in 1987 and $0.6 billion over the next five years.

Institute Home Health Copayment

Previous restrictions and limitations on the use of home health services were eliminated in the Omnibus Budget Reconciliation Act of 1980. Since then, home health spending has increased over 20 percent annually. In order to encourage more cost-conscious behavior on the part of beneficiaries, we are proposing to require a modest copayment on home health visits. This copayment would be equal to one percent of the

inpatient deductible and would apply to all home health visits, except those (1) within 60 days following an inpatient hospital or skilled nursing facility stay for a condition related to the stay, or (2) visits provided after 100 visits in a calendar year.

We will also enhance our medical review of the appropriateness of home health services by focusing attention on physicians who show patterns of ordering unnecessary visits, or of not closely monitoring patients' needs, especially patients who receive more than 100 visits annually.

These proposals will result in savings of $100 million in 1987 and $0.6 billion over the next five years.

Make Medicare the Secondary Payer for the Working Aged Over 69 and Disabled Spouses and Dependents

As a result of changes made in the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984, Medicare is now the secondary payer for beneficiaries aged 65-69 who work and who are covered under employer-based health insurance or who are covered under a working spouse's plan.

This proposal would make Medicare the secondary payer for beneficiaries over age 69 if they or their spouses work and elect employer-based health insurance. The combined insurance protection afforded beneficiaries under this proposal will always be at least as comprehensive as Medicare alone. In addition, the secondary payer provision would be extended to

disabled beneficiaries who are also covered under a working spouse's employer health plan.

This proposal would result in savings of $540 million in 1987 and $3.2 billion between 1987 and 1991.

Medicare Part B Premium and Deductible

We are proposing modest increases in the Part B premium and deductible.

When Part B was first established, premiums paid by individual beneficiaries represented 50 percent of program costs. Over the years, premium increases have not kept pace with increased health care costs and, as a result, premiums now cover only 25 percent of costs, with the general fund subsidizing the remaining 75 percent. We propose to move closer to the original balance between the premium and the general fund subsidy by increasing the premiums paid by beneficiaries two percentage points each year for the next five years. By 1991, the premiums will be at a rate equal to 35 percent of estimated program costs.

For third-party payers who buy Medicare Part B coverage, the premiums would be set at 50 percent of costs as required by the original legislation. This primarily affects States which pay the Medicare premium for their Medicaid beneficiaries and avoids an unnecessary duplication of Federal subsidies for Medicaid beneficiaries.

This proposal would increase Medicare premium income by $725 million in 1987 and by $17.2 billion through 1991.

We also propose to raise the Part B deductible from $75 to $100 in 1987 and then index it to the Medicare Economic Index beginning in 1988. This provision would help maintain the real dollar value of the deductible, which has been increased only twice since Medicare was established: from $50 to $60 in 1973, and to $75 in 1982. Current law does not provide for future increases in the deductible. If the original deductible had kept pace with increases in medical inflation it would be $241 today.

Increasing the Part B deductible to $100 in 1987 and indexing it to the Medicare Economic Index through 1991 would save $310 million in 1987 and $3.0 billion through 1991.

Expanded Enrollment Opportunities

This proposal would expand opportunities for Medicare beneficiaries to use their health benefits to enroll in a wider array of private health plans as an alternative to traditional Medicare coverage.

In 1982, Congress, with the support of the Administration, amended the Medicare statute to permit payments on a risk basis to Health Maintenance Organizations (HMOs) and competitive medical plans. Our current proposal would build on this provision. This initiative would permit Medicare to contribute an amount related to what it would have cost to care for the beneficiary if he or she had elected traditional Medicare coverage. These plans would be required to provide a benefit package that is at least equivalent to that provided by Medicare. The program would be entirely voluntary, and beneficiaries could elect to re-enter the Medicare system if they choose to do so.

First Full Month of Eligibility

We propose to begin Medicare eligibility on the first day of the month after an individual reaches age 65. Currently, Medicare eligibility can begin before an individual attains age 65.

This change should not result in a lapse of health insurance coverage because the large majority of individuals have private insurance which generally extends until the beginning of Medicare coverage.

This proposal is expected to save $265 million in 1987 and $1.6 billion through 1991.

Modify Payments for Non-Physician Items and Services

We propose to reform non-physician services (primarily durable medical equipment), now reimbursed on a reasonable charge basis, to ensure that Medicare does not overpay for these services.

Evidence indicates that Medicare is paying excessive amounts for these services. Under this initiative, reasonable charge levels will be reviewed, and payments will be revised where appropriate to reduce overpriced charges. This proposal will save $70 million in 1987 and $0.5 billion over the next five years.

Maintain Clinical Laboratory Fees

Consistent with the overall policy of limiting the unnecessary growth in health care costs, Medicare reimbursement for laboratory services performed in clinical laboratories, physicians' offices, and in hospital outpatient departments would be maintained at existing levels for one year.

In addition, when the fee schedule for tests performed in hospital outpatient departments expires in July 1987, reasonable cost limits will be established by regulation to preclude excessive spending for hospital laboratory services. We expect savings of $55 million in 1987 and $0.2 billion over the next five years.

Other Medicare Proposals

The Department's 1987 budget also proposes to save $141 million in 1987 by: revising the process for determining whether payments to providers should be made for noncovered services; changing return on equity capital payments made to facilities other than inpatient hospitals; imposing the standard Part B coinsurance and deductible for surgery done in ambulatory surgical centers; and by simplifying processing of Medicare Part A bills.

Status of the Medicare Hospital Insurance Trust Fund

As you know, just three years ago, the Hospital Insurance (HI) Trust Fund was predicted to be bankrupt by 1987, given estimated revenue and income projections. However, as a result of this Administration's efforts in reforming hospital reimbursement and introducing more competition into the health care sector, the rate of growth of Medicare outlays has declined significantly. Projections now indicate that the fund will remain solvent until close to the end of the 20th century, under current economic assumptions. The Department is now updating its projections of the trust fund status and current information will be available this Spring.

INCOME SECURITY

(Function 600)

The Department's income security programs for the aged, disabled and poor will have estimated outlays of $23 billion in 1987. This is a net decrease of $468 million below the 1986 level.

SUPPLEMENTAL SECURITY INCOME

The 1987 outlay estimate for the SSI program is $10.5 billion, an increase of $373 million over 1986. Federal benefit payments under this program will provide assistance to an average of 3.9 million recipients each month.

The increase in benefit payments reflects a cost-of-living increase of 3.7 percent and a projected increase in the eligible population.

AID TO FAMILIES WITH DEPENDENT CHILDREN

A total of $8.2 billion in outlays is included in the 1987 budget for the AFDC program. These expenditures will provide assistance to an average of 3.7 million families each month.

The request includes several legislative proposals, three of which continue proposals previously made in this program. They are intended to ensure that assistance is provided only to

those who are in need and who are not in a position to provide for themselves, and that strong work requirements exist for all able-bodied applicants and recipients. In 1987, these legislative proposals are estimated to save $237 million in AFDC; through 1991, savings would amount to about $1.2 billion.

The specific proposals are as follows:

Reform Welfare Administration

To give States an incentive to lower their rapidly-growing administrative costs, the 1987 budget proposes to reduce Federal matching rates from 50 percent to 25 percent to those States where per recipient administrative costs exceed 175 percent of the national median. The reduction would apply only to those costs which exceed the 175 percent threshold.

The Department also proposes to reduce, and eventually eliminate, the higher matching rate for statewide data systems development. Initially, the reduction would be from 90 percent to 75 percent (consistent with the current matching rate for these activities in the Food Stamp program). This rate would continue for three years to allow States to complete their statewide systems development. After FY 1989, Federal matching would be at the regular 50 percent rate for administrative costs. Together, these two proposals are expected to reduce administrative costs by $15 million in 1987.

Mandate Job Search and Work-related Activities

States will be required to have all employable adult AFDC applicants participate in job search and all employable recipients register and participate in job search and other work activities. States will have flexibility to structure their requirements for both job search and work activities (which could include Community Work Experience programs, work supplementation, or on-the-job training). This flexibility will also allow States to continue sucessful work alternatives now being run under the Work Incentives demonstration authority. Savings to AFDC are estimated at $52 million in 1987 and $214 million through 1991.

End Caretaker Benefits When Youngest Child Turns Age 16/ Essential Person Limitation

This proposal would exclude caretaker relatives in calculating AFDC benefits when the youngest child reaches age 16. This is similar to ending benefits for spouses with children in their care when the youngest child reaches age 16 under the Social Security Old Age Survivor's and Disability Insurance programs. The proposal would not affect the child's benefits, but recognizes that these adults are sufficiently free from child care responsibilities to pursue employment. This proposal would also limit essential persons (those in the household whose needs and income are considered in determining the AFDC grant) to those needed in the home to care for a child

or incapacitated adult. This latter change is necessary to insure that rules for essential persons conform to the changes being proposed for caretaker relatives. Savings are estimated at $101 million in 1987 and $529 million through 1991.

Require Single Minor Parents to Live With their Parents to be Eligible for AFDC

This proposal would require States to withhold eligibility from minor parents who have never been married and who establish separate households, unless certain conditions exist, for example, a situation where the health and safety of the minor parent would be jeopardized if they lived with their parents. This proposal seeks to discourage the practice of minor parents leaving the home of their parents to claim AFDC. Savings are estimated at $20 million in 1987 and $106 million through 1991.

CHILD SUPPORT ENFORCEMENT

Vigorous implementation of changes made by the Child Support Enforcement Amendments of 1984 will continue to be a major priority in 1987. We estimate that total child support collections will have more than doubled since 1980, from almost $1.5 billion to almost $3.3 billion in 1987, an increase of 8 percent or $249 million compared to 1986. Of this amount, almost $1.3 billion will be collected on behalf of AFDC families. The 1987 budget reflects outlays of $729 million for this program. The budget also includes two legislative proposals intended to further strengthen incentives for more cost-effective operations, as follows:

Accelerate Reduction in Federal Financial Participation for State/Local Administrative Expenses

Under current law, Federal matching for State and local administrative expenses is scheduled to be reduced in two steps from 70 to 66 percent by 1990. The Department proposes, however, to implement a further reduction to 66 percent in 1987 rather than in 1990 as currently scheduled. While lower, the 66 percent matching rate remains generous compared to other entitlement programs, and strengthens current incentives for more cost-effective, performance-related operations, a goal endorsed by both the Administration and the Congress. Moreover, States which improve their performance by operating more efficiently will be able to qualify for increased incentive funds--currently financed entirely by the Federal government. This proposal is estimated to save $39 million in 1987.

Reduce Enhanced ADP Matching

The Department is proposing to phase out enhanced funding for the design and development of child support enforcement computer systems by 1990. Under our legislative proposal, the 1986 rate of 85.69 percent would be continued through 1987, reduced to 75 percent in 1988 and 1989, and eliminated completely in 1990. Thereafter, these activities would be matched at the prevailing rate for State and local administrative expenses of 66 percent.

This proposal allows States sufficient time at enhanced rates to complete modifications required by the 1984 amendments. By 1990, States will have had almost a decade in which to design and implement automated systems with enhanced Federal matching. This legislation is estimated to save $2 million in 1987.

LOW INCOME HOME ENERGY ASSISTANCE (LIHEAP)

The 1987 budget requests a $2.1 billion appropriation for LIHEAP.

SPECIAL BENEFITS FOR DISABLED COAL MINERS

The 1987 budget request of $962 million is $34 million below the 1986 appropriation. Black Lung benefit levels are maintained at current levels throughout FY 1986, and a 3.0 percent COLA increase is payable in January 1987. The $34 million decrease in the FY 1987 request reflects the continuing decline in the number of beneficiaries receiving payments administered by SSA.

REFUGEE AND ENTRANT ASSISTANCE PROGRAMS

In 1987, the budget request for Refugee and Entrant Assistance programs totals $374 million in budget authority.

This represents an increase of $52 million above the level of funds available in 1986, but includes $79 million of costs previously funded from other accounts.

Legislation proposed for 1987 would finance all refugee cash and medical assistance through this account under program rules more tailored to refugees' circumstances. This change would cause a $109 million increase in funding for Refugee and Entrant Assistance that would be offset entirely by reductions in the AFDC and Medicaid programs. Another component of the proposed legislation would limit to 18 months the period for which States receive full payment for aid to needy refugees. This change saves $30 million, compared to the cost of the current 36-month period of full repayment to the States, for a net change of $79 million due to proposed legislation. In view of the lower and more stable refugee arrival rates of recent years, no funds are requested for targeted assistance or educational assistance.

SOCIAL SECURITY

(Function 650)

The Department contributes to the income security of aged and disabled Americans through the Old Age, Survivors and Disability Insurance (OASDI) program. OASDI outlays constitute about 62 percent of the HHS budget and will provide assistance to approximately 38 million Americans in 1987. This represents

an increase of $12.1 billion in outlays compared to 1986. The budget for these programs reflects implementation of the Social Security Disability Benefits Reform Act of 1984, as well as continued improvement in the financial position of the Trust Funds under provisions of the Social Security Amendments of 1983.

Growth in OASDI outlays is due primarily to an estimated increase of 703,000 beneficiaries; a higher average benefit amount due to higher earnings of newer beneficiaries; and to payment in January 1987 of the annual cost-of-living increase currently estimated at 3.7 percent.

The budget also includes the effects of a pending legislative proposal to accelerate collection of Social Security contributions from State and local government employers. This proposal would yield over $1 billion of accelerated payments and recurring interest over the next five years, including an estimated $317 million in 1987.

As required by the Balanced Budget Act, the budget reflects the restoration of the Social Security Trust Funds to the position that would have resulted it the constraints imposed by the debt ceiling had not necessitated early redemption of securities and less than full investment of fund balances in 1984 and 1985. Since trust fund balances are normally invested in full in special issues of U.S. Treasury securities and

redeemed in order of maturity, the temporary inability of the general fund of the Treasury to incur the debt associated with routine operations of the Trust Funds would otherwise have caused a loss of interest income of approximately $382 million. Restoring this revenue to the Trust Funds has no effect beyond that which would have occurred through routine operations.

MANAGEMENT ACTIONS

Finally, Mr. Chairman, this budget reflects important management changes at HHS which will continue to save money and improve administration of our programs and services for the public--including significant changes recommended by the Grace Commission. Of the approximately 300 Grace Commission recommendations directly related to HHS, almost 90 percent either have been or are being implemented, or effective alternatives proposed. Implementation of these recommendations has improved HHS management efficiency, with a substantial dollar savings.

We estimate that, when fully implemented, actions which we have taken to date or have proposed in the 1987 budget will save the Federal government $14 billion in 1987. These savings include the dramatic increase in efficiency which we have already achieved from implementation of the hospital prospective payment system under Medicare, new legislative and regulatory

proposals in the 1987 budget and specific management improvements which have increased staff productivity in the Department.

The 1987 budget also proposes to rescind $787 million in 1986 budget authority. In general, these proposals seek early elimination of programs previously identified as unnecessary or ineffective or initiate reductions in the second half of 1986 as a means of moderating reductions that would otherwise be required in 1987 under the President's Budget. Major proposals include:

- o $182 million for elimination of funding for the Community Services Block Grant in the second half of 1986.

- o $164 million for termination of support for Health Professions Education and Health Planning.

- o $102 million in funding for the National Institutes of Health and the Alcohol, Drug Abuse and Mental Health Administration to provide a necessary transition to a stable level of 19,400 project grants in 1987.

- o $88 million for Refugee and Entrant Assistance to reduce excessive spending on activities that were helpful in 1980 when the influx of refugees was very large and immediate but which are no longer necessary now that the flow of refugees is much smaller and relatively stable.

- o $45 million for phase-out of the Work Incentives program in 1986 as a prelude to legislation for a new Work Opportunities program under AFDC in 1987.

EFFECT OF THE BALANCED BUDGET ACT ON HHS PROGRAMS IN 1986

FY 1986 budget estimates include the effect of the mandatory sequestering provisions of the Balanced Budget Act. These provisions require a total reduction in Federal outlays of $11.7 billion, of which $5.85 billion is to come from non-defense spending including selected HHS programs. Because more than 70 percent of HHS outlays are totally exempt from reductions and other programs are subject to special rules, sequestering of HHS budgetary resources in 1986 results in outlay reductions of just over $1 billion as follows:

- $354 million from Medicare and other programs subject to special rules such as Child Support Enforcement, the Indian Health Service, Community and Migrant Health Centers, Foster Care, and Adoption Assistance.

- $681 million from a 4.3 percent across-the-board reduction for all programs not otherwise subject to special treatment.

- No reductions are included for benefit or vendor payments from the exempt entitlement programs: Social Security (OASDI), Supplemental Security Income, Aid to Families with Dependent Children, and Medicaid. However, the spending authority associated with the Federal cost of administering these programs is subject to sequestering of 4.3 percent.

Mr. Chairman, this Administration has reversed the trend toward escalating costs which was jeopardizing the retirement income and health care of elderly Americans, impairing program discipline and effectiveness, and often producing unacceptable waste and fraud. The policies and programs put into place from 1981 until now have succeeded.

Our goals for the future are no less important: finishing the task of securing health care benefits for this Nation's elderly, working with the States to provide quality health care for the poor in a cost-effective way, continuing this Nation's preeminence in biomedical research, promoting self reliance and supporting the family as a pivotal institution in this society.

That concludes my remarks, Mr. Chairman, and I would be happy to answer your questions at this time.

The CHAIRMAN. Thank you very much, Mr. Secretary. We are deeply appreciative of your presence, the work that you are doing, and your testimony to us today.

Let me begin by asking, do you seriously believe that with a 22-percent reduction in Federal funding, States can continue to provide the normal services under the title 20 Social Services Block Grant, as well as provide supportive services for WIN enrollees, assuming the activities of the Community Service Grant and fund a legal service program with the current title 20 funding? Aren't we asking a little too much there, expecting a little too much?

Mr. BOWEN. We are asking a lot, and it will require innovative and creative answers to difficult problems. But I think that it can be met if we do many of the things that we think ought to be done.

The Social Services Block Grant, for example, does provide productive services for older Americans and our children. It will and does establish day care, helps to prevent child abuse, helps to serve meals to our older Americans. It provides, or we provide for the Head Start Program which has been a very, very popular one, and we are serving 448,000 children, and there will not be any need for reduction in the number of children served, and there will not be a need for reduction in services.

As far as the nutrition programs for the older Americans, we served in 1986 210 million meals. In 1987 we anticipate that that will be increased to 222 million meals, and it is anticipated that we will be better able to manage the program through perhaps such

things as menu planning, which can be better done and better collection and more community support.

The families' social services programs for foster care and adoptions is not going to be hurt at all. There will be Federal funds to reimburse the States on a matching basis, and there will be no reduction in the number of children served.

I just don't believe that we are going to be hurting these people if we use the innovative and creative ideas that I know will exist.

The CHAIRMAN. Well, Mr. Secretary, we have had some field hearings around the country, as you know. When we asked State and local officials about the ability to make up for some of these cutbacks in providing services, we didn't find one. The political persuasion was irrelevant. None of them seriously thought that they could, through new innovative ideas alone, replace the services. Because the services could not be picked up by anyone else, all of them testified that there would be a significant drop in the provision of those services.

At this time the Chair recognizes the gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Chairman, I would first like to again, as you have, welcome the Secretary, and bemoan a little bit the absence of our Republican colleagues. I had hoped that they would participate more actively in these hearings, particularly with administration witnesses. Dr. Bowen is certainly a respected individual and heads a very important department of our Government, and I had hoped that we would have our colleagues from the other side of the aisle here participating with us.

Dr. Bowen, I chaired the regional hearings that were conducted in Dallas, and part of our hearings dealt with health. I also am chairman of the Health Task Force of this Budget Committee, so I have a particular interest in this matter. And we did have some excellent testimony from a variety of witnesses on the health aspects of the President's budget, and my office and the committee here will be happy to provide that testimony for you, if you have not already seen it.

I would like to ask you a couple of questions about some things that were raised at that regional hearing in Dallas last week. Many hospitals under the Medicare proposals will be greatly harmed by the 50-percent reduction in payments for indirect medical education, because they use this payment to help subsidize the hospital bad debt from low-income patients.

What do you suppose will happen to hospitals with large numbers of low-income patients if the 50-percent reduction for indirect medical education is approved?

Mr. BOWEN. I don't believe that they are going to be hurt that much. Even with the proposed changes that the budget allows for payments to hospitals to go up, they will still go up a little over $1 billion, and the question of reduced indirect medical education will be $1.1 billion, and that will affect teaching hospitals, of which there are about 800 out of the 6,864 or so, and the reform of the direct medical education again will affect only the teaching hospitals, and that amount would be five-tenths of $1 billion. So this is a 4.4-percent decrease for the inpatient hospital services.

The hospitals with, as I see it, with high Medicare utilization will still receive a little higher capital payments and the reduced—again, indirect and medical education—will affect only the teaching hospitals.

The hospitals, by their own reports, are doing pretty well financially, and their net operating margins and their inpatient costs have also gone down. In the AHA reports of 1984, it states that their total net operating margins were 5.1 percent, compared to 4.2 percent in 1983, and that patient revenues, including Medicare, rose 6.9 percent in 1983, and that the AHA also—their data indicates that inpatient costs were down about 1 percent in 1985.

So I think that the hospitals do have innovative methods of becoming more efficient and more productive, and can absorb these, and I don't mean it may not be without some pain, but we are charged with coming up with means of reducing the budgets, so that we can be balanced by 1991, and this is a method that we feel———

Mr. FROST. Well, Mr. Secretary, of course, some of these teaching hospitals serve center city populations very heavily, and I am specifically thinking about Parkland Hospital in Dallas, TX. Let me ask you a related question about the disproportionate share allocation, and your Department's intentions in that regard.

I understand that the Department is in the process of developing a formula to assist limited numbers of hospitals with large numbers of low income patients. However, I am concerned that most hospitals in need still would not be helped under your formula.

For example, during our committee's hearings in Dallas, Dr. Ron Anderson of Parkland Hospital testified that his facility would receive no assistance under your formula, even though his hospital is only able to collect 28 percent of patient revenue. Why wouldn't your formula help hospitals like Parkland?

Mr. BOWEN. I will have to get the answer to that. I do not know. I am not familiar with the———

Mr. FROST. Well, could you tell me exactly what you are doing on the question of the disproportionate share? Because this is something that has been controversial, it is something that the administration has had to be dragged kicking and screaming into including, and it's in our reconciliation legislation, which is pending, as you know, and it is not something that the Department under your predecessor embraced with a great deal of enthusiasm.

Mr. BOWEN. Well, as I recall, the most recent studies show that there is great question whether there are differences in disproportionate share in the various hospitals, and our Department is studying that question at the present time, and at the present time there has not been evidence to support any adjustment in that. But we are continuing to study it, and obviously will———

Mr. FROST. Mr. Secretary, even though that's mandated under the legislation that was passed several years ago—I mean that was set out in law as passed by Congress that there would be a disproportionate share. And as I said, your Department has not exactly embraced this concept.

Mr. BOWEN. Well, I think they have not embraced it simply because they have not seen any evidence to really support the adjustment.

Mr. FROST. Well, Mr. Secretary, I would suggest to you that when Congress provides that there is to be such an adjustment, that it's up to your Department to do it. I have problems with selective enforcement of the law, or selective administration of the law.

Mr. BOWEN. Well, I trust you realize that I have only been here 60 days, and I am not aware of all of the studies and all of the answers, but if you will permit me, I would ask Dr. Desmarais, who is more knowledgeable about that, if he would come to the table and answer your question.

Mr. FROST. Please. We would certainly like to hear from him.

Mr. BOWEN. Dr. Desmarais.

Dr. DESMARAIS. First, I should say there is a lot of confusion about what exactly disproportionate share means. Basically it is not an uncompensated care issue, it is a question of whether Medicare reimbursement is appropriate in a hospital where there is a lot of low-income patients, and the question is, how would one define such a hospital, and second, what is the adjustment.

Now, once you have defined that hospital, what is the appropriate adjustment? We have been doing a lot of work, as has the CBO and others, to examine that question, and we are fully aware of the reconciliation provisions and the debate that went on. Of course, there was some discussion about using percent Medicaid as a definition, but when people looked at the statistical work that underlaid that, they found first this tremendous variability in Medicaid programs across the country, and in your own State, of course, a definition that's predicated on percent Medicaid would likely disadvantage the providers in the State of Texas.

Mr. FROST. Particularly since Medicaid is being frozen under your budget.

Dr. DESMARAIS. Oh, no; it's related basically in decisions the State of Texas makes.

Mr. FROST. I understand, but there are limits once you—what the State can do once you freeze the figure.

The CHAIRMAN. Can I interrupt the dialog? I just realized something.

Mr. Secretary, would you identify for the record the member of your staff who is at the microphone now, so we could just have it on the record.

Mr. BOWEN. Yes. This is Dr. Henry Desmarais, and he heads the Department of Health Care.

The CHAIRMAN. Thank you. We just wanted to have that on the record. Please continue.

Dr. DESMARAIS. So that Medicaid definition didn't seem appropriate to us. We were uncomfortable with it, and what we are doing right now is actually studying the question further with the hope that in the next prospective payment regulation, we could be prepared to propose an appropriate definition and an appropriate adjustment.

As you have pointed out, at the end of December, under court order, we issued a definition. We made clear at that time that we were not comfortable with that definition, but that we were simply complying with the judge's order; that we felt we needed further study to come up with the right definition.

Mr. FROST. I just would reiterate, Mr. Chairman, that this is something the Department has been studying for some time now, for several years, and I would hope that the studies could be brought to a conclusion and that we would be able to act some way other than the Department being mandated by a Federal court to do what it ought to have been doing several years ago, and this is not an idle question. There are a number of hospitals that serve a disproportionate share, a large number of low income patients, under Medicare, and we ought to be able to figure out how to define this and get on with it and help those hospitals, and that is my only point.

The CHAIRMAN. The Chair recognizes the gentlelady from Illinois.

Mrs. MARTIN. Thank you.

The CHAIRMAN. Ranking minority member of the committee today. Mrs. Martin.

Mrs. MARTIN. We welcome you. I understand you have been testifying more than you have been able to administer lately, spending your life over here.

I am not sure, Doctor, why you wanted to leave the beauties of the Hossier State and head the Department, but considering the rare combination of administrative, political, and medical skills that you possess, it makes you an excellent choice for the Department, and we all look forward to working with you.

Although I might not share totally my colleague's concern in blaming the Department, I think he does make a good point on a teaching hospital. I say that not because I have one that works exclusively with or even with the majority of low-income patients, but I do believe that's a very special program in America. I would hope the Department could come up with a definition so that there is not within the formula harm to those hospitals. Because especially in large urban areas, they make a real difference.

Could I ask where you are coming up, doctor, or your staff, with some of these numbers? You indicate, for instance, that there will only be a 2-percent increase in inpatient hospital services, yet a lot of other people think that that percentage just isn't real, that it will be much higher than that. Can you tell me where you got some of these assumption numbers that are within the President's budget? And I realize you are new, but could you tell me where?

Mr. BOWEN. May I call on one of my staff?

Mrs. MARTIN. Please. Please.

Mr. BOWEN. Dr. Desmarais again.

Mrs. MARTIN. Dr. Desmarais.

Dr. DESMARAIS. The 2 percent is a placeholder, as you have identified it, and it's based on some educated guesswork about——

Mrs. MARTIN. May I just interrupt? Placeholder? We have a new Federal word. Who made it up and what the heck does it mean?

Dr. DESMARAIS. It is not a new word. I think I have seen it used before. It's basically a best estimate at this point of what the increase might be, but it's not a firm concrete number, because the law requires the Secretary to consider a number of factors, including the recommendations of the Prospective Payment Assessment Commission, which comes out April 1, in making a judgment about what the actual update ought to be.

But for purposes of putting the budget together an assumption was made.

I think the other thing we ought to remember is when we look at the update and we think 2 percent, that everybody thinks, well, that's a 2-percent increase in payments. That is not necessarily true. The update only applies to one piece of the formula, and there are many pieces.

So, in fact, as we have observed, you could not change the payment rate, you could provide no increase, and still payment amounts would increase, because other pieces of the formula are going up; like case mix, and we have observed some artificial increases in case mix solely due to better coding of Medicare cases.

So there's a kind of a complex interaction. I am not sure whether I have answered your question.

Mrs. MARTIN. It's your best estimate, but that estimate has been questioned by others, and if you are wrong, that's going to make a pretty sizable impact on our budget.

Dr. DESMARAIS. Yes; that's correct.

Mrs. MARTIN. And on those of us trying to come up with a budget.

I'm wondering if we could move to another area and, doctor, perhaps again from your experience, the administration is proposing a Work Fare Program. Could you make some comments on how you will do this in terms of young mothers? What will the exemptions be, and the changes that you have in aid to families with dependent children, and what you are attempting to achieve by these changes?

Mr. BOWEN. Well, we are, of course, attempting to achieve more independence by the individual.

Mrs. MARTIN. Well, one of the changes that you're making is that they have to stay at home with a parent.

Mr. BOWEN. Right; we feel that that will do two things: No. 1, it will help to strengthen the family and, of course, there will be exceptions to that. If the individual has already established a separate home, that would be an exception. Or if there would be dangers to the individual because of having to remain at home, that would be an exception.

Mrs. MARTIN. Mr. Secretary, I don't necessarily oppose that, but how does that argue for independence?

Mr. BOWEN. Well, as I think I mentioned, that would support the family concept more than the independence one. Also the individual would have to register for the Work Opportunities Incentives Program, if she were employable and if she were physically able to do so. And this is a program which would require job search. It would require active work. It could be in a subsidized job with grant diversion to industry paying a part of the salary and the AFDC part of the salary and there could be community work experience, and also the participation in the Job Training Partnership Program.

These would be—the rules would be such that within 3 years, 75 percent of these would have to be in actual working positions. That would be 25 percent the first year, 50 the second, and——

Mrs. MARTIN. There's an age limit, isn't there, doctor? I mean it's not going to be teenage mothers under 16. You can't really send them out to the workforce.

Mr. BOWEN. Obviously we have to have that in consideration, but the employable—and that would come under the definition——

Mrs. MARTIN. I do think Work Fare is a good idea. I'm very interested. I'm going to be very blunt—that some of these decisions are not made only by those people who have never really experienced what that is like; who frankly have never been mothers; that are all overwhelmingly male—and this has nothing to do with the administration, but that there are actually people asked questions of women, black, white, Hispanic, that are going to be the most affected by these decisions. So that there is not a view which is often not true, but still held, that the decision is being made by someone who lives in a very expensive house in Washington, DC, and doesn't know anything about what's happening down on the streets. And I please ask you, as a doctor who has worked in that field, to include more often than you ever thought you would before, women in making those decisions because, frankly, they affect women the most.

Now the young male, regrettably, is not part of this family you have mentioned too often, and it is the girl who is raising that child.

Mr. BOWEN. I agree with you totally on that, and in my remarks in the last couple of talks I have made, I have stressed the fact that we are blaming the young girls too much and eliminating the fact that the young boy is equally at fault, or more so——

Mrs. MARTIN. I'm just asking within your department that they not all be in pinstriped suits making the decisions.

Mr. BOWEN. Thank you.

Mr. FROST [presiding]. The Chair recognizes the gentleman from Massachussetts, Mr. Atkins.

Mr. ATKINS. Mr. Secretary, let me congratulate you on the general direction in this budget of moving away in the welfare system from simply benefit payments for people to work opportunities.

I, however, have some real reservations about what you are doing, and I think in many ways your program and direction may destroy some of the few successful State programs for work opportunities for welfare recipients.

Under your budget, you would propose over a 3-year period of time a mandatory job search community work experience for virtually all welfare recipients except that small group that might be exempted.

In my State of Massachusetts, we tried that program. It was enormously costly for the State, and resulted in very few people going off the welfare rolls.

We then switched to a program that utilized the Job Training Partnership Act funds which in the President's budget are cut by $400 million, the WIN Program, which is totally eliminated, and some State funding, and now have a program which is considered to be the best in the country that has 1,000 people a month going off of caseloads into productive jobs, and almost none of those people have come back over the 3-year life of the program, so far, onto the program.

And what I see happening in this budget is the administration cutting funding for the tools that the States have to use to make work opportunities a reality and to reduce welfare caseloads, on the one hand; and on the other hand, imposing a set of bureaucratic restrictions and regulations which run counter to the President's emphasis on a new kind of fiscal Federal relation with the States.

I'm wondering about your comments on that and whether you are open to changing the direction of that program?

Mr. BOWEN. First, let me congratulate the State of Massachusetts for what they have accomplished. I think that there has been some misunderstanding, that even though the WIN Program that we have recommended phasing out, that doesn't mean that it is not going to be replaced with something we feel would be better. And the——

Mr. ATKINS. If I might just interrupt, where will the funding for that something better be?

Mr. BOWEN. I'll try to go through what the—the comparisons here. The Work Opportunity Incentives Program will give States like Massachusetts, with their ET Program, considerable discretion in the design and the operation of their State Welfare and Work Program. But unlike the Massachusetts program, the work opportunities incentives, as I mentioned a while ago, would require that within 3 years, 75 percent of the employable recipients would be in work activities.

The Work Opportunities Incentives Program actually would have very little effect on the Massachusetts Education and Training Program, because the ET is actually mainly State-funded. It is my understanding that Massachusetts spent about $40 million, with only about $8 million of that coming from the WIN money, so that about $32 million of that actually came from the State funding. And the WIN funding would be replaced by the funds from title 4-A.

Mr. ATKINS. That would be dollar for dollar replacement under that?

Mr. BOWEN. Currently the States get a fixed amount for the WIN Program, at least 10 percent Federal funds matched by State funds. But under the Work Opportunities Program the costs of implementing and operating these programs would be reimbursed by an open-ended title 4-A, and with the Federal funds at 50 percent matching rate. And I believe—my aides can correct me if I'm wrong—I think that there is about $200 million Federal money with 50 percent matching money to the State, could be made $400 million that would be available through the open-ended account.

Mr. ATKINS. The other problem with your program, though, having gone through this in Massachusetts, is that Massachusetts program was successful because it essentially targeted on those people on the welfare caseload who were most ready and most anxious to go into the workforce, and was able to get them into the workforce, as opposed to setting up a huge State bureaucracy to go through a process of job search for people, many of whom had all kinds of barriers to employment. And if you force the State, in order to be eligible for continued Federal funds, to focus—essentially what you would be doing is changing our emphasis from outputs, namely people getting jobs, to inputs, namely people being forced

to go through a job search—you inevitably—and this has happened around the country—have people engaged in meaningless kinds of job search activities, simply to meet the Federal requirements and to avoid the Federal sanctions, rather than having people placed into jobs and reducing the cost to both the State and the Federal Governments.

Mr. BOWEN. By and large, the WIN Program nationwide—I'm not talking about Massachusetts—have been rather ineffective, and it is for that reason that we felt that the change should be made, and with your permission I would like to ask JoAnn Ross, who heads our Family Services, to make some further explanation on that, if you would permit.

Mr. ATKINS. Certainly.

Mr. BOWEN. All right. JoAnn, would you do that?

Ms. Ross. Thank you, Mr. Secretary.

I am JoAnn Ross, Associate Commissioner for Family Assistance, and I have the responsibility for administering the AFDC Program and, therefore, the work proposal that this Department is putting forth as described by the Secretary.

The situation with the WIN Program is the regular WIN Program has been criticized for a number of years by a number of different vantage points, including the GAO a number of years ago, which found that the regular WIN Program was largely a paper process. It focuses on registration, and that only about 20 percent of the people were actually involved in some kind of work activity.

The Massachusetts program, which you describe, and you and the Secretary have engaged in a dialog on ET, is operated under what is called WIN demonstration authority. And that WIN demo authority came into being in 1981.

Mr. ATKINS. Now you are quite correct, and I think that focuses on exactly the problem with your new approach, because what you are doing with your new work opportunities approach is focusing once again by creating the requirement that 75 percent of the welfare caseload go through a job search program. You are getting back into the paper program aspect of having people required just to do something on paper and the State required to show something on paper that says that people did something, rather than getting people into jobs.

And, as a matter of fact, in Massachusetts, we originally under the WIN Program went through exactly that job search activity that you are now recommending nationwide, and it was an absolute disaster. You had people sitting there with the Yellow Pages calling randomly as their job search activity through the phone book to ask for jobs, rather than any more constructive thing in terms of actual placement of people into jobs.

Ms. Ross. Well, we want to get at the actual work activity, which is precisely the reason we put forth our proposal. And, in fact, job search can mean a lot of different things in different places. Many States have implemented job clubs, job support groups, all those things fall under the terminology of job search, and are acceptable.

I personally have visited job clubs operating in the State of Texas, where it's a very support group oriented process, where people are taught how to fill out a résumé, how to fill out an application form, how to apply for a job. And, in fact, in San Diego, CA,

and in Arkansas—those are the two locations where we have very excellent scientific research that was done based on a control group, in terms of looking at what would have happened without job search and work experience—we had a control group, random assignment. The control group basically had the old WIN services. The experimental group went through job search and community work experience, and in both of those locations the job placement rate for the individuals participating went up between 19 and 23 percent.

Another good example is the State of Pennsylvania which operates largely a job search and community work experience combination program. And in the first year of operation the State of Pennsylvania increased placements 56 percent.

Mr. ATKINS. Let me just suggest, if I might, I would hope that you would try to maintain flexibility in all these programs and focus on getting people into jobs, rather than job search process and rather than arbitrary requirements for so many people going through job search, which would direct States onto simply a search, rather than a placement.

Ms. ROSS. I would assure you, sir, that absolutely that's what we are interested in doing. We are not interested in perpetuating a process that leads no place, but rather in identifying the most effective techniques proven throughout the demonstrations that have been conducted across the country.

Mr. FROST. At this point, the Chair has several questions by a member of the committee who could not be here today, Congresswoman Barbara Boxer from California, and these will be placed in the record, and we would appreciate it if the Secretary would provide answers in writing to these questions at a later time.

Mr. BOWEN. I would be glad to do so.

Mr. FROST. The questions are made a part of the record.

[At the time of printing replies to the questions had not been received.]

Mr. FROST. The Chair recognizes the gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

Mr. Secretary, according to the information I have, your Department was to have issued a report in October 1984 on the method for including capital cost in the prospective payment system, and you were also to have submitted a legislative proposal designed to implement this recommendation.

It is my understanding that 1½ years after the date at which this report was to be submitted, we have not received it. I'm just curious that the administration's fiscal year 1987 budget includes a regulatory proposal to fully incorporate the Medicare payments of capital cost into the prospective payment system by 1991.

The administration estimates a savings of $456 million in fiscal year 1987 under this proposal with a 5-year savings of over $11 billion.

Since the Congress doesn't have the report that we were supposed to have in 1984, I am just interested in whether you can tell us if the Department has studied the impact of this proposed change on hospitals all across the country and especially those in

rural areas. Tell us what you're doing in this area, will you, Mr. Secretary?

Mr. BOWEN. Well, I can assure you that there has been adequate study, and I will make a few little remarks concerning it, and then would ask Mr. Helms to continue.

Mr. SLATTERY. Is it true that we don't have that study? I certainly haven't seen it, the one that was supposed to be submitted in October 1984. Is that study done?

Mr. BOWEN. I will have to ask in the back here.

Mr. HELMS. My name is Bob Helms. I'm Assistant Secretary for Planning and Evaluation.

I don't think the Secretary should be blamed for not having the report.

Mr. SLATTERY. I don't mean to blame him. I'm just curious where it is.

Mr. HELMS. But I would say that within a very few days, the Secretary should be able to submit that to the Congress. It's going through the final stages of clearance. The early chapters in the report have all been submitted in more technical form to the Congress in a series of reports, and we have studied the impact of this, particularly on rural hospitals. And as a gross generalization, I would say that I think our evidence is that rural hospitals will probably come out a little better under this proposal than they would have under the continuation of cost reimbursement.

Mr. SLATTERY. I'm just curious; does your study indicate that some hospitals are going to experience rather dramatic cuts in the reimbursement for capital cost, while others are going to actually experience increases? What does your information tell you about how the money is going to be distributed?

What was your name again, for the record?

Mr. HELMS. Bob Helms.

Mr. SLATTERY. Helms, OK. Thank you, Mr. Helms. What does your study indicate, Mr. Helms?

Mr. HELMS. First of all, it's an averaging approach, and I think you have to realize that there will be some gainers and losers. But the people that stand to lose the most are the ones who have very high capital obligations under what we call the high-capital-cost hospitals, the ones who have recently gone through some kind of reevaluation, refinancing, or recent construction projects which have come on line.

Now to take care of that, we are proposing a 4-year transition to let those people phase out of the old system into the new one. But the major impact would be on those, we think.

Getting back to an earlier question, we think one of the people—the sets of groups of hospitals that will be helped by this proposal are those who have had relatively low capital amounts, and they tend to be some of the inner-city hospitals, some of the public hospitals, and they will probably come out a little bit ahead on this proposal.

Let me also say, about the $11.5 billion savings, that really comes from an actuarial estimate based on past behavior. For the last several years, capital has been going up 14, 15 percent a year, annual Medicare payments out of the trust fund to hospitals.

The actuaries simply projected that out over the next 5 years as their estimate of current policy at a 14-percent increase per year. And that's what the actuaries have to do. So our proposal comes out with a very large savings number, and I would caution you, though, that that estimate doesn't have any kind of behavioral effects about what's really happening to hospitals in the marketplace, and I don't think—I was reading last night, some experts in one of the hospital magazines talking about all of the competition that hospitals are getting into from HMO's and other entities.

Mr. SLATTERY. Mr. Helms, we're under the——

Mr. HELMS. They don't think that increase would really go—it would not continue to increase at 14 percent.

So I think our proposal levels out the capital payments, but I think the hospitals, the factor that is really going to affect them in the future is the increased competition.

Mr. SLATTERY. OK. Let me ask you something else related to this.

Basically, what we're talking about doing, of course, is freezing hospital reimbursement under the prospective payment plan. There aren't going to be any appreciable increases there.

And I'm just curious, is it realistic for us to expect hospitals, many of which have had to expend substantial amounts of capital to improve outpatient facilities, so as to decrease inpatient cost, and they've had to incur capital costs for maintenance and other reasons other than expanding their operation, is the point that I'm making, and I'm just curious, in light of our plans to freeze the prospective payment plan reimbursement, and then to squeeze in the capital costs under that reimbursement, is this realistic?

I mean, where are the hospitals going to make up the difference? And I would point out to you that in my State of Kansas, we're looking at a situation now where 53 percent of all of our hospitals in the State are currently operating at deficits. They're not paying their bills right now.

I'm just curious, you know, is your proposal a realistic one, in light of the fact that hospitals, half of them aren't paying their bills right now, and many of them are facing the prospect of making decisions with respect to whether they are going to be able to continue operation or not?

And the percentage, I would point out to you, is substantially higher in rural areas, where you're in a situation where maybe 60, 70 percent of the hospitals currently are not paying bills.

Mr. HELMS. Well, let me first say, as the Secretary and Dr. Desmarais said earlier, the decisions about—there has been no decision to freeze the update factor at this point. As a matter of fact, as we called it, a placeholder of 2 percent is in there, and the Secretary is going to be looking at all evidence, as he is required to do, to determine that on the operating side.

When you add in the capital side of it, I think it is reasonable. We tried to study the impact. We tried to look at what's happening in the marketplace.

I think there are some special problems of rural hospitals, and I said before, those, I think, are due not so much to Medicare as to other factors that are happening in the marketplace.

Mr. SLATTERY. OK; my time has expired.

Mr. HELMS. But our analysis indicates, I think, that rural hospitals will be slightly better off than they would have been under the cost reimbursement.

Mr. SLATTERY. OK; my time has expired.

Are we going to have an opportunity to ask another series of questions?

Mr. FROST. We are operating under a liberal time limit, so that if you want to ask additional questions, please proceed.

Mr. BOWEN. Could I add one point to that?

The current system really helps to subsidize unoccupied beds, and this will be a method to help them correct that.

Mr. SLATTERY. OK; I had another question unrelated to the Medicare problem, and this goes more to sort of a philosophical question, I guess, that I would direct to the Secretary.

One of the things that I've become increasingly alarmed about is the sharp increase in the number of children in this country that are living in poverty. And when you look at the numbers, it's staggering.

I think one of the great success stories, perhaps, in this country over the last 15 years has been the fact that we have been able to dramatically reduce the poverty rate among seniors in this country. It's something we should all be proud of.

But since 1980, there has been a dramatic increase, maybe a 30-percent increase, in the number of children in this country living below poverty. We have millions of kids in this country that are living in homes where the income level of the household is one-half of the poverty rate, and that is destitution.

Mr. Secretary, I'm just curious, from a philosophical standpoint, what role do you believe that the Federal Government should play, if indeed it should play a role, in addressing this problem? What is the conservative, sort of philosophical response to this problem?

I assume you are a conservative, consistent with the President's philosophy. What is the conservative political response to the dramatic increase in the poverty rate among children in this country that we've experienced in the last 5 years?

Mr. BOWEN. Well, first let me say that Government is not going to be able to do much about it unless we get improved morality, improved participation of parents, improved participation by communities, by our churches, by our schools and everyone.

One of the biggest causes of the problem that you mention, of course, is the fact that 51 percent of all children now of teenagers are out of wedlock, and, of course, that immediately puts them into a position of going—a great many of them; in fact, I would say a majority of them—going into the AFDC types of programs.

So Government cannot be the mother and the father and the counselor and the guide for these types of problems. We have to stimulate our people to attack it.

Now Government does have a role, and I could tick off a whole list of things that they are doing, but I'm sure you are familiar with most all of them. We do have a—in the 1987 budget, we have $26.7 billion for 15–G children's programs, and this is up $366 million over 1986, and it's up over $1.9 billion over 1985. So it isn't that we are anti this; we are very cognizant of it and want to do everything that we can to correct it.

Children just have to be served, and we intend to continue to serve them. For example, 11.4 million of these are served on Medicaid, and that's 375,000 more than were served in 1986, 700,000 more than were served in 1985. Seven million are served in AFDC, and 3.3 million of them are being served in the Social Security benefits.

Head Start has a half a million or just short of a half a million people, and there's $1.075 billion that will be contributed to that.

The Public Health Service has $857 million for programs aimed at children through their maternal and child health programs, through immunization programs and on and on.

Mr. SLATTERY. I appreciate what you're telling me, Mr. Secretary, and I appreciate the fact that we have slightly increased, perhaps, our commitments in some areas while cutting it in other areas. But obviously there are some inflation factors involved here, too. So the cold data that you give me is somewhat misleading.

But I'm just curious. That doesn't take away from the fact that there has been a 30-percent increase in the poverty rate among kids in this country, and now we still have maybe 20 percent, according to a lot of studies, of our kids under age 15 living below the poverty line.

You know, I guess my question to you is, are we doing enough in this area, Mr. Secretary? And I'm happy to hear you admit that you believe that the Federal Government does have a role to play in addressing this problem, and I think that's a very important statement, obviously. But I'm just curious. Are we doing enough in this area?

Mr. BOWEN. You can never do enough as long as we have the types of figures that you said. But we have to balance the needs of the beneficiaries with the needs of the various providers and with the needs of the taxpayers. And obviously children would come high on anybody's list of those that need help.

Mr. SLATTERY. One last question, sort of following up on this. You have proposed and estimated that there will be approximately $777 million in savings realized by some corrections in the excess errors in the AFDC Program. I'm just curious, how did you arrive at that figure? What sort of process did you go through to come up with a savings of $777 million for fiscal year 1987, I believe it is, by improving the error rate in the AFDC Program?

Mr. BOWEN. I'll have to call for some help.

Mr. SLATTERY. OK.

Mr. BOWEN. This is JoAnn Ross.

Ms. ROSS. Yes, sir; the $777 million estimate comes from the erroneous expenditures in the AFDC Program, considered from 1981 through 1985. And if you look at those and apply the targets as established by the Congress, the limitations for Federal financial participation—for example, for 1981, 1982, and 1983, the States were to move one-third closer to their target.

Mr. SLATTERY. What is their target?

Ms. ROSS. Their target of 4 percent for 1984—excuse me, for 1983—and 3 percent for 1984 in the outyears. Those were targets established by the Congress.

Mr. SLATTERY. OK; Now basically what you're suggesting, then, is that the savings that the Federal Government is going to be real-

izing due to this change or this proposal is actually payments from the States to the Federal Government for overpayments in the period, 1981 through 1985; is that what you're telling me?

Ms. Ross. No, sir, not exactly. Let me try to clarify. It is a complex area. First of all, this is not a proposal. This is already current law.

Mr. SLATTERY. Well, in the budget, though, you're anticipating savings of $777 million, and I'm just curious how you arrived at that figure. That's a substantial amount of money, obviously.

Ms. Ross. Yes, sir; the way we arrive at that figure is—and perhaps could I give you an example of one year, and then I think that might make it clearer.

Mr . SLATTERY. Sure.

Ms. Ross. For example, in 1981, States misspent a total of $1 billion. It's like $987 million, but roughly $1 billion.

Mr. SLATTERY. OK.

Ms. Ross. Of that $1 billion, half of it was Federal funds and half of it was State funds.

Mr. SLATTERY. All right.

Ms. Ross. Of the roughly $500 million Federal funds that were misspent, $69 million of that is below—or excuse me—$73 million of that was below the 4 percent. It was the money that went up to the 4 percent, the $73 million.

Mr. SLATTERY. OK.

Ms. Ross. OK. Not really the—when I say 4 percent, it was 4 percent for States, 6.7 percent for some.

Mr. SLATTERY. I understand.

Ms. Ross. OK.

Mr. SLATTERY. That was the margin of error they were allowed.

Ms. Ross. Correct, correct, yes. Thank you. Thank you for helping me.

Of that $73 million, the States applied for waivers, so they would not lose the $74 million and have to repay it to the Federal Government. Secretary Heckler granted waivers to some States but not to all States, and, in fact, the Department proceeded to try and collect $69 million of the $73 million.

So the $777 million that we have in the budget for fiscal year 1987 represents the $69 million from 1981, and I can give you specific figures, but roughly $180 million for 1982, so many million for 1983, 1984, 1985.

Mr. SLATTERY. But the money that you are talking about is coming from the States, though; is that correct?

Ms. Ross. It is coming from the States. That is correct.

Mr. SLATTERY. So you're going to be sending a bill to the State of Kansas for whatever amount that they have erroneously paid in excess of what's the acceptable margin of error?

Mr. BOWEN. Indiana is going to get one, too.

Mr. SLATTERY. Pardon me.

Mr. BOWEN. Indiana is going to get one, too.

Mr. SLATTERY. So there will be bil's sent to the States. Have you informed the Governors of the States to anticipate a billing from HHS?

Ms. Ross. Secretary Heckler did inform the States, based on the 1981 decisions. For fiscal years 1982, 1983, and 1984, the error rates

have been issued to the States. The potential disallowance, as we call it, has not been issued to the States, nor have the States applied for their waivers yet. So that process still is forthcoming. States will have an opportunity——

Mr. SLATTERY. So you're going to be submitting a bill—now let me make sure I understand this.

What you're projecting for budgetary purposes this year is a savings of $777 million for fiscal year 1987, and to achieve that projected savings, what you're telling us is that you're going to be submitting bills to the States for their excess error payment for years 1981 through 1985; is that correct? Is that what you're telling me?

Ms. ROSS. It's not really submission of a bill, sir. It's actually a deferral of Federal financial participation that would be provided to the State in the next year.

Mr. SLATTERY. Let me just put it this way. What you're talking about doing is reducing payments to the States or collecting from the States, whichever way you want to say it, $777 million in fiscal year 1987, which is to make up for overpayments of 3 or 4 years; is that correct?

Ms. ROSS. That's correct. But I would like to explain one thing.

Mr. SLATTERY. OK. All I'm saying is that I think it's very important for the Department, and I would again ask you, have you notified our Governors of the 50 States approximately what kind of a bill to expect, because this is a sufficient bill that you're talking about submitting to them or a significant amount of money that they will otherwise not be receiving?

Ms. ROSS. That's the one piece that I want to explain, if I may.

Mr. SLATTERY. Please do.

Ms. ROSS. We walked through the example of the $69 million, and I explained that it's the combination of that equivalent figure for each year, is how we reached the $777 million. The situation is that the $777 million assumes no waivers, and Secretary Heckler did grant waivers in 1981. We have always done that historically as a budget assumption.

Mr. SLATTERY. Now wait a minute. The $777 million does not assume waivers?

Ms. ROSS. That's correct, sir. It does not.

Mr. SLATTERY. So we're looking at a very soft number here, then.

Ms. ROSS. It's not a hardest one. The situation is that we have no basis ahead of time for guessing what States would be granted waivers and which ones wouldn't, and so therefore we have always, for the past 4 years, assumed collection of all the disallowances, and the decisions for 1982 and beyond have not yet been made. I think that's an important point.

Mr. SLATTERY. I would observe that the President's budget that was submitted to the Congress came in at 143.8.

In terms of the Gramm-Rudman target for 1984 and if we are very soft with this number, we are over the target just on this one little matter in the HHS budget. We came real close, I would observe, to the Gramm-Rudman target, and it looks to me like we have a real soft number to work with in terms of projecting our savings for fiscal year 1987.

Don't bank on it, then, is what you are saying. Don't bank the $777 million.

Ms. Ross. What I was saying is that we will do our best to meet the number, but also we have no basis for making determinations about anticipating which sets would be granted waivers or would not be granted waivers.

Mr. SLATTERY. I am sure you have probably heard the point that I'm going to make, and that is that, well, we are talking about a margin of error. I think in Kansas they are working with a margin of error out there of about 4 percent, if I'm not mistaken. It's awful close to that, and the problem they tell me they have is that whenever you are administering a program involving thousands and thousands of people, which they are in a State like Kansas even—and I'm sure in New York it is even much greater and in California is much greater—and they tell me that there is a point beyond which it costs more to squeeze down the margin of error from 3 percent to 2.5 or 4 percent to 3.5 than you can save by squeezing down that much more.

Do you see what I'm saying? They are saying that the Federal Government is coming out and telling them squeeze this down, and we are all trying to do the best job we can to administer all of these programs, and we all support squeezing efficiency out of these programs in every way we possibly can.

But the point the States make is, of course, they are sitting out there and saying if you give us a 4-percent margin of error and if you penalize us if we don't get down to 3.8 percent or whatever it may arbitrarily be set at, it may cost us more to get to 3.8 percent than what we are going to save by getting there.

Do you see what I'm saying? They make a very, very convincing argument on that point. When you are talking about 4 percent of a $300 a month grant, I mean it gets down to talking about a dollar, almost, and it's very difficult sometimes to squeeze that out.

So what I'm saying is we better be looking at this from a State perspective, too.

Ms. Ross. I do understand the point you are making, and at the same time, I would point out that during 1981 the national average error rate was around 7.5 percent, and that 7.5 percent error rate netted almost $1 billion in misspent money in AFDC, which is a significant amount of dollars.

Mr. SLATTERY. Absolutely. We have made great progress now because it is down, isn't it, significant?

Ms. Ross. Yes. In 1984 it was down to roughly 6 percent. We are making progress, clearly, but even so, the erroneous expenditure was still around $800 million. So each percentage increase in the error rate or above the target accounts for a substantial amount of Federal and State dollars.

Mr. SLATTERY. Thank you.

Mr. DERRICK [presiding]. Doctor, I would like to pursue some of the areas that Mr. Slattery has been pursuing in just a moment, but tell me what you have done, if anything.

Mr. BOWEN. Sir, I can't hear you with the extra noise outside here.

Mr. DERRICK. I would like to pursue some of the questions that Mr. Slattery has raised, but first let me ask you what have you done, if anything, so far on this catastrophic insurance matter that I think the President directed in his state of the Union message

that it be looked into, and what do you project and when do you expect to have a report for the Congress?

I have noticed, I think, in some of your remarks or somewhere I have seen that you suggested that it was going to come out revenue neutral.

Mr. BOWEN. Yes, the proposal that I have previously talked about would be revenue neutral, but let me state that this was an article that was written in conjunction with Tom Burke before I ever knew that I would be sitting in a position such as here. I do think that the two big, blank areas in the Medicare Program are, No. 1, the catastrophic illness costs for acute illnesses, and No. 2, the catastrophic illness costs for the long-term care or nursing home care.

We had proposed one thing, that the President's message broadened the charge to include the catastrophic coverage for everyone and included the request of joint efforts in the private and government cooperation.

So we are in the process of determining the parameters of this study, and we have not completed that yet.

Mr. DERRICK. Do you have any figures even tentative, yet, about what kind of floor you are talking about on your catastrophic, or how you are going to handle that? I am also interested in what your projection is about it being revenue neutral. It seems to me it would be anything but revenue neutral.

Mr. BOWEN. Let me outline very briefly our thoughts previous to my becoming Secretary of HHS.

Mr. DERRICK. By the way, Mr. Secretary, I wish you the best of luck. I don't envy you.

Mr. BOWEN. Thank you very much. I appreciate it.

We are looking at several options for the President's report, and one of the options will be the one that I recently talked about, which would be cost neutral. It would be funded through the part B premium, and it would permit unlimited hospital days for acute illness with no coinsurance and with a maximum of two deductibles for the hospitalization or part A.

It would have a limit of $350 on the amount that an individual would spend under part B, the physician's fee, but of course that $350 could be any limit you wanted to put it, and the higher the deductible, the less you would pay. The lower the deductible, the more that one would pay.

Also, it would eliminate the 12.5-percent coinsurance for the skilled nursing home care for days 21 through 100. It would eliminate, really, the need for Medigap insurance, which is a big cost to the beneficiary, and not oftentimes, but the amount of the Medigap insurance would be considerably higher than what the increase in the premium of part B would be to the beneficiary.

It was costed out that under part A. it would cost about $3.33 more per month to get the unlimited number of hospital days, and of course, the reason it can be so low is that there aren't that many people who are hospitalized over 60 days when the bills begin piling up so fast. You could spread that over 30 million people, and you would say that makes the cost low.

Mr. DERRICK. How do you reconcile that with your prospective payment that the administration seems to be pushing so hard as far as your hospitals are concerned?

Mr. BOWEN. I'm not sure I understand.

Mr. DERRICK. Your prospective payment puts a limitation of so many, *x* numbers of dollars, as I understand it, for each particular illness or reason for going into the hospital. What sort of limitation do you put? I mean how do you discipline your hospitals?

Mr. BOWEN. Well, I don't think that would be any problem at all. I think the rules are in place that govern that now. I think even the economics of it would be such that it wouldn't make any difference at all.

Mr. DERRICK. Thank you. Thank you, Mr. Secretary.

Let me just, in the brief amount of time I have here, I represent a rural area, and as Mr. Slattery pointed out, I think in Kansas maybe 60 or 70 percent of the small hospitals are in dire financial straits. I know I was at home this past weekend and was talking with a friend of mine who is a doctor there.

He went to school with me and he was telling me that our local hospital, which is a small hospital, was in danger of closing down. As a matter of fact, he thought they could probably handle it maybe by using some of the rooms for some other sort of care other than hospital care for a while, but he eventually thought it was going to be closed down.

The hospital may be marginal financially to begin with because it is a small hospital—I think it has about 45 beds or something like that—but still, it rendered a tremendous service to the community.

One of the problems, as I understand it, that they are having is that the classification for reimbursement is urban as opposed to rural. One of the things that they mentioend to me that they run into, although this is a rural hospital, it is within 30 or 40 miles of an urban area, and they run into this problem of competing with the urban salaries but yet being reimbursed on a lesser basis because of the rural status of the hospital.

I wonder if you have looked into this at all and if there have been any decisions made about it?

Mr. BOWEN. There is, admittedly, discrepancies between the rural and urban areas not only with the hospitals but also in the physician reimbursement problem between various specialties and locations in the country. I know that studies—and I may have to have some help on the exact extent of the studies—but there are studies going on now concerning the differentials between the rural and the urban with reference to wages, with reference to how close a rural hospital may be to an urban center, and the fact that some of the rural hospitals have been—and I suspect some more in the future can be reclassified as sort of treatment centers to help to improve the situation.

With your permission, I would like to ask Dr. Desmarais to assist me on that answer, sir.

Mr. DESMARAIS. I think to start, we should remember that in December 1982 when Secretary Schweiker sent the administration's prospective payment report to the Congress, it made no distinctions

between urban and rural hospitals for payment purposes. The Congress, on adopting the proposal, decided that was appropriate.

The outcome of that is in most instances the urban payment rates are higher than the rural payment rates. However, Congress also said we, the Department, needed to examine this whole issue to see whether, in fact, that was the right thing to do: Should we continue to make distinctions, do rural hospitals need some kind of special protections?

That study is underway.

Mr. DERRICK. When could we expect to have the results of that study?

Mr. DESMARAIS. We would hope to have it later this year.

I would also point out, of course, as a result of congressional decisions as well as——

Mr. DERRICK. Excuse me, but could you be a little more definite than just you hope to have it the latter part of this year? I have a couple of hospitals that it means a great deal to.

Mr. DESMARAIS. I would be happy to submit a more specific timetable for the record, sir.

Mr. DERRICK. Thank you, sir.

Mr. DESMARAIS. As I was saying, however, there are a number of protections for rural hospitals. Sole community hospitals are given special protection under the system. Hospitals that are rural referral center are given special protections. There are a number of safeguards that have been put into place while we do study the situation.

Finally, we improved the wage index, which many people felt disadvantaged the rural hospitals, the old Bureau of Labor Statistics——

Mr. DERRICK. That has been improved recently.

Mr. DESMARAIS. Well, not yet because Congress has put it on hold until March 15, so we have not been able to implement and use this revised and refined wage index. But we have to do so shortly.

Mr. DERRICK. Thank you very much.

Just an observation on this matter. Of course, you know, we talk about saving all this money as we cut back on these programs. Of course, what happens is that what you are doing is just shifting the obligation. You are shifting it to the patient who can pay because the charges that are made to him must take into consideration these unpaid bills of the poor, and you are also shifting it to the local taxpayer, usually the ad valorem taxpayer.

So I think to say that we are saving a great deal of money, you may be saving some, and I certainly hope you are, but really what you are doing is shifting the tax burden back to those who can pay, and the ad valorem taxpayer.

You have a tremendous problem. I don't know what the answer to it is.

Let me ask you one question, and then I will stop. Just generally, looking down the road, do you see us ending up here over the next few years with a two-tier medical services in this country, one tier for those who can't pay and one tier for those who can pay, the latter being superior for the former? This has been suggested to me by several doctors as not necessarily what they want but what they see as the only way we can come out of the situation we are in.

I understand the problem. If you are in the hospital, you want the best services that can be provided, and if a machine costs $2 million, you don't care if it costs $10 million if it's something that is going to help you.

Mr. BOWEN. That is one of the dangers that we have to guard against, and I would hope that it will never happen, and I have faith that the medical profession and the government——

Mr. DERRICK. Where is the money going to come from, though? You know, we are cutting back, and yet these costs are continually rising, and I am sure there are some savings that could be made everywhere, and hopefully we will do our best to maximize those, but the fact of the matter is that if we are going to provide quality medical services for the people of this country on an equal basis, where is the money coming from?

Mr. BOWEN. Well, you put your finger on the problem a little bit ago here when you said when an individual is ill or a member of his family is ill, he ceases to become an economical person. He says to do everything possible. That is one of the problems, and it is difficult for the medical professional not to do everything.

Mr. DERRICK. Of course, he is faced with the possible malpractice situation if he doesn't do it.

Mr. BOWEN. Which opens up another big area as to the cost of med icine. I think that we are headed, and I hope as rapidly as we can, into increased competition and competition methods which I think would help to prevent the two-tier system, but that is going to take a little time to ease into this.

Mr. DERRICK. Do you think that your programs or your direction is headed in that direction?

Mr. BOWEN. Yes.

Mr. DERRICK. You do. All right. Thank you very much for your testimony, Mr. Secretary. Mr. MacKay.

Let me say before you start that I received a call a few minutes ago from Chairman Gray. He regrets very much, Mr. Secretary, that he won't be back this morning. He has been called to a meeting in the Speaker's office on reconciliation, which also concerns what we are doing here this morning, but he asked me to express to you his regrets that he won't be back and to thank you for your testimony.

Mr. MACKAY. Dr. Bowen, I apologize that I was late and I was not able to hear your statement to the committee or the earlier questioning.

There are two areas that I have a particular concern about and would like to ask you about. One of them is child support, and the other is refugee assistance.

My understanding is that the effort, which is a joint Federal/State effort on child support, has begun to pay real dividends in the sense that the States are becoming more aggressive in attempting to enforce child support orders, and the savings to the Federal Government, since many of the people who benefit from collecting child support payments are the same people who are on various welfare programs, particularly AFDC, the Federal Government has got a real stake in the success of this program.

It seems to me that the budget submitted is counterproductive in two respects. One, it proposes to cut down on the reimbursement to

the States for gearing up their computer systems in a way that tie in with the Federal computer system; and two, it accelerates the time at which we will reduce the reimbursement to the States for gearing up this program.

It seems to me, in this era of trying to make a Federal system work, essentially the breakdown in the system hurts the Federal Government. If the States don't collect child support, the Federal Government's AFDC budget goes up. It seems to me this is the most counterproductive thing we could possibly do.

Mr. BOWEN. That is something that obviously we need to correct if it does exist, but I think what our department is attempting to do is to stimulate the States to be more effective in the collections, and if that occurs, then I don't think that it is counterproductive. Of course, their duties are to locate the absent parent and to establish paternity, and then to enforce the enforcement orders.

There are many examples of how they have been advised to proceed with that: Wage withholding, and offsetting the various State and Federal income tax returns, and the expedition of the various court actions, and then establishing interstate cooperation to get the parents who move from one area to the other; using banks for collection agencies, and even, in our State, our prosecuting attorney even put out a "Ten Most Wanted" list and advertised in the paper for them, and he got more than the 10 most wanted. He got a lot of extras that came in.

Mr. MACKAY. Florida has a record of aggressive enforcement, and as a person who has practiced law there, I have been astounded at what can happen when a judge just summarily puts—well, in one case in my home county, the judge put 136 recalcitrant fathers in jail one day at noon. It astounded the sheriff because he didn't have room for all of them. It also astounded the recalcitrant fathers who suddenly realized, gee, this thing is serious, and it had a tremendous and lasting impact on child support payment rates.

I am very sympathetic to the effort. What I am saying is in a Federal system where you can't force the States to do this and where the burden of their failure to do it falls on your program, it seems to me you would be trying to increase the reimbursement as an inducement to the States and not reduce it.

Mr. BOWEN. I think the only answer I can give to that now would be that we are, again, under the gun by 1991 to have a balanced budget, and in our best efforts of trying to apportion out where the expenses should be, that that's the way it falls. But I can assure you that the child support program will be followed closely, and it has been very successful and we have no reason, really, to believe that it isn't going to continue to be successful.

Mr. MACKAY. Dr. Bowen, I am familiar with a pilot project in the State of Wisconsin which is called the Wisconsin Child Support Project. I don't know if your agency is following it closely, but I would recommend that you do. In essence the Wisconsin program as a matter of public policy does not leave the question of payment of child support to the courts to decide.

It simply says: if you father a child, you are going to pay 18 percent of your total wages for that child until he or she reaches adulthood, and if it's two, then it's 23 percent, and so forth. It says that we are not going to wait for the courts to enforce it; it is going

to be automatically deducted on a payroll deduction plan, and it is going to be sent to the State, it is going to be compared to the amount that would come under a poverty program. If the father's wage is a minimum wage and it is reduced, then the State will add the amount to it necessary to bring it up to minimum wage.

It will be sent to the mother whether the mother is working or not, and the program seems to be having a phenomenal impact, and the people who are following it from the Poverty Center at the University of Wisconsin say that it carries the potential of reducing AFDC payments in Wisconsin by as much as 48 percent.

Mr. BOWEN. You have touched upon something that is of great interest to me. The very day that came out in the papers, I drew attention to it to our department and said, I like it, let's look into it, let's follow it. I think this would have great impact upon increasing the parents' attention to what their children are doing, and I think that it would help to decrease the amount of teenage pregnancies, and certainly we are going to follow that very, very closely. It holds, I believe, the grandparents liable as well as the father.

Mr. MACKAY. Yes, that's correct.

Mr. BOWEN. I like the idea and we are going to look into it very, very closely.

Mr. MACKAY. The other question I wanted to ask on refugee assistance is the reverse of the situation that we had in child support. In child support we have one where if the State system breaks down, the Federal Government is holding the bag. In refugee assistance, if the Federal program breaks down, the States and local governments are holding the bag.

It seems to me to be very unfair for us to say we are going to balance our budget by reducing the assistance to State and local government, reducing the reimbursement time for refugee assistance. I don't understand the rationale of that. I am from Florida, and it seems to me Florida and California are going to bear the brunt of that. They are already bearing the brunt of illegal immigration, which is a further breakdown of Federal policy, and I would like to register an objection and say you appear to be a humanitarian person. How can you do this to us?

Mr. BOWEN. If I were a governor, I would complain also, sir. But I think that again, it is a matter of being obligated to look at every opportunity to reduce Federal expenditures, and I know that this is one area where it would be more sharing with the States with the reduction of the 3-year period down to 18 months. I recognize that as a legitimate complaint.

Mr. MACKAY. I guess the only other question I have follows up on the earlier question that Mr. Derrick was raising about the proposed catastrophic coverage. The catastrophe in Florida comes in the failure to reimburse for long-term nursing home care. I didn't understand your answer. I'm not trying to be adversarial; I just didn't understand.

Does your proposal treat long-term nursing home care as a catastrophe?

Mr. BOWEN. Sir, I didn't have the opportunity to complete my discussion on that. That would be phase 2 or part 2 of the program. I don't know of any immediate solution to that problem, and

there is no one more aware of it than I am because my mother has been in a nursing home for a year and a half now, and I know who pays the bills.

A program that I have advocated—and again, don't mistake this for any administrative proposal. I am stuck with this, which I'm not averse to being stuck with it, but I wrote this previous to the time that I knew that I was going to be in a position like this. I have suggested the utilization of an individual medical account comparable to an IRA. As I say, that is not going to solve the problem tomorrow, but you have to start sometime on this type of a very serious problem.

The expense of putting it into a present program would be astronomical. I want the problem to be solved and I want to be a part of the solution of getting it started as soon as we can.

Mr. MACKAY. I am sure you have followed the impact of what long-term nursing home care is doing to the Medicaid Program in Florida. It is essentially going to preempt the entire Medicaid Program, and it is posing the issue of pitting the needs of the elderly against the needs of people in poverty in Florida.

Well, that would be all right except that Florida is about 20 years ahead of the rest of the country, and the rest of the country on the exact same road as Florida. How long do you have to wait before we start trying to figure out how to resolve it.

Mr. BOWEN. I guess that is a question that you are going to have to help answer along with the Department.

Mr. MACKAY. We all understand that the underlying question behind this is are you getting policy input or is OMB running social programs in this country. It sounds to me as if in your answers you are being very guarded.

Mr. BOWEN. I think you understand why I am guarded. It is because I feel a little insecure having been here only 60 days. I am not insecure as far as the administration goes. I have had no objection or no complaints at all, but insecure as to the type of answers that I give to you.

Mr. MACKAY. I have not been here too much longer than you. Let me say that you have less to fear from this committee than you have from OMB, based on the careers of your predecessors. [Laughter.]

Mr. BOWEN. I appreciate that.

Mr. MACKAY. Thank you.

Mr. BOWEN. I have had cooperation thus far and I have had input. I think we have had a little success. I have a lot to learn yet.

Mr. WILLIAMS [presiding]. Mr. Secretary, I want to add my welcome and congratulations to that of the other members of this committee. It is nice to see you here before us today. We appreciate your coming.

On October 9, 1984, the President signed, as you know, the Family Violence, Prevention and Services Act. That legislation was fairly well accepted by the American people and by the Congress. It passed the House with only 4 dissenting votes, 396 to 4, which is almost an impossibility in the House. The vote in the Senate was even more supportive. It passed 89 to 0.

In my capacity as chairman of the subcommittee which has jurisdiction over this legislation, I requested of your predecessor to issue

regulations implementing this legislation. This was clearly not an outrageous request. The request was made 6 months ago. Of my colleagues 60 have written asking that the regulations for that legislation come forward. As you will remember, during your confirmation hearings, you promised to issue the regulations within 90 days and you are now 60 days in office.

How are you doing with these regulations? Are you close to completion?

Mr. BOWEN. Yes; we are getting very close. As you have mentioned, I did state to Senator Packwood on his question that we would have that in place in the 90 days. I think we are going to be on schedule. If you want, I might ask exactly where we are on it.

Mr. WILLIAMS. Please; I would appreciate that.

Mr. BOWEN. We will try to get you a specific date. I can assure you I do not take promises lightly. I have been asking about that very frequently. We will get an answer to you.

Mr. WILLIAMS. I understand your concern. I know of your promise and we are sure you will keep it. The purpose of my question is not to doubt in any way your promise to the Senate and now to the House, but simply to remind you that we are eager to see this very popular and well supported piece of law, in fact, become law and begin to be administered.

In your budget, Mr. Secretary, you propose legislation to consolidate several existing programs into a program of family crisis and protective service grants for the States. Do you have a plan on when you are going to make that legislative proposal public?

Mr. BOWEN. Our 1987 budget would consolidate three of the child abuse grants and the family violence categorical programs into a new program called what you just said, the family crisis and protective services grants.

I can't give you the date other than it will be forthcoming shortly.

Mr. WILLIAMS. We are obviously eager to see the proposal and know just how you plan to consolidate the programs and still provide the appropriate delivery of those services.

Mr. BOWEN. We think with consolidation that it will be more efficient delivery and we will get more for the dollar spent.

Mr. WILLIAMS. We are very eager to see that result.

Just a few weeks ago the President gave his State of the Union Message to the Congress which was quite good and typically Ronald Reagan. It was an uplifting speech which showed an America that I think all of us want to reach. He paid particular attention in that speech to his concern, and America's concern, about strengthening the family. There is only so much that any administration, any Congress, or the Federal Government can do to assist in strengthening the family.

You are the Secretary in one Department that has, I suppose, this objective as its primary charge. We have heard the President's speech and now we have the budget, which is the roadmap to achieve his goals. Clearly, it is the roadmap to achieve an America with stronger families.

I know of no Member of Congress who thinks you can create a stronger family just by throwing money at it. I do not think you get a stronger Grenada by just throwing money at it either. But as

we found out in Grenada, we also know, as Americans, that you have to spend some money to make improvements.

My question is to the facts of your budget. Outside of the entitlements, which is money that under law you must spend, do you ask for an increase or a decrease in those Federal efforts which after 6 years are fairly well proven to work, after you have taken out Social Security, Medicare, Medicaid, SSI, and AFDC, since these are entitlements, and the money has to be spent?

What do you do with the rest of the budget to get us to Ronald Reagan's bright, uplifted America with strong and secure families? That is, Mr. Secretary, what do you do with such programs as family social services, low-income energy assistance for our poor families and our grandmothers, child support enforcement, alcohol and drug abuse treatment, and mental health administration, which is so vital to families in trouble? Are we going to dismantle these programs or are you and the President asking for a good, aggressive Federal policy and maybe just an inflationary increase for these programs?

Mr. BOWEN. This is a very broad subject. I think that the discussion we had earlier on the children and programs we have tried to emphasize would answer your question. We have, for example, $26.7 billion for 15 key children's programs. This is up $366 million over 1986 and it is up $1.9 billion over 1985. We will also be serving 11.4 million children in Medicaid, and that again is up from 1986 by 375,000 and actually up 700,000 over 1985. We will be serving 7 million AFDC children and 3.3 million will receive Social Security benefits. That had the cost-of-living adjustment to it.

The Head Start Program serves 448,000, which is a record high. There would be $1,075 billion spent on that program. In the area of public health for children, the maternal and child health care, we will spend $857 million for programs aimed at children. The collections for child support will be $3.3 billion in 1987 which is an increase of about 8 percent even over this last year.

In areas for health of children, we have a record low on infant mortality, which is now at 10.4 deaths for 1,000 live births. We are going to spend $60 million on the infant mortality initiative, which is $6 million over 1986. Over 95 percent of all children will have been immunized. Again, that is strictly for health of children and family.

The social services block grant is funded at the full authorized level of $2.7 billion. Almost all of the States use these funds for day care. There are 46 States that have emergency protective systems helped by the Federal Government. There are 37 that are utilizing the various adoption services. The adoption services' funds are up 30 percent above 1986, serving 24,500 people. We think that the Work Opportunities Program for AFDC recipients will be of help.

I think on and on, we could go with various programs that would help to strengthen the family. I still go back to what I said a while ago that Government cannot be a mother and father and a guardian to all children. It is going to take more effort from people. It is going to take more effort from parents and communities, from schools and churches, to make that a reality.

Mr. WILLIAMS. I appreciate that, Mr. Secretary, and recognize that many of the efforts which you have said need increases, do

need those increases. Some of those efforts of which you spoke, however, are entitlements, which are locked and therefore must increase.

Mr. BOWEN. Yes.

Mr. WILLIAMS. I am some concerned because if you took the current services, meaning you just allowed the people who deserved these services to have them, and you also built in inflation, we estimate that you would be asking for $10 billion less than you need. Of course, that cannot come out of entitlements, nor should it come out of entitlements. So, therefore it must come out of those discretionary dollars, the $10 billion less than you need while keeping up with current services and adding a little bit for inflation.

Our Budget Committee has obviously looked at your budget. We just aren't sure about your proposals. There is obviously more looking to do. We just aren't sure that it is the correct roadmap to get us to that America which Ronald Reagan speaks of so well.

I might just say before we let you go that Americans think we have a lot of other problems which also affect the family. Disease, as you know better than I, Mr. Secretary, is a very serious problem in America today, Gramm-Rudman or no Gramm-Rudman. Cap Weinberger is going to have to wait a while because we do need to delegate some money to the problems of disease and we need to do it to a larger extent than we are. At least as one member of the Budget Committee, I don't think your budget reflects the type of effort that we have to make if we are going to take care of the real serious disease problems that are affecting America.

Mr. Secretary, with the Budget Committee, you have a great deal of work ahead of you. Many of us on this committee look toward your leadership as we try to reach that America of strong families and good health. In that endeavor, we want to assist you and we also wish you well. We thank you for being with us today.

Mr. BOWEN. Thank you very much. I do look forward to working with you and the entire committee.

Mr. WILLIAMS. The record will remain open for several days for additional questions and remarks. This hearing of the Budget Committee will be in recess.

[Whereupon, at 11:40 a.m., the hearing was recessed until 2 p.m.]

AFTERNOON SESSION

The CHAIRMAN. The committee will now come to order.

Today the Budget Committee will hear from Dr. Rudolph G. Penner, Director of the Congressional Budget Office. Dr. Penner, I welcome you and thank you for coming. Dr. Penner is here today to testify on the Congressional Budget Office's economic and budget outlook, a report that provides us with CBO's baseline budget projections, numbers that are now more important than ever in the Gramm-Rudman era of deficit targets.

Members should understand that these projections are prepolicy. They are not a reestimate of the President's budget proposals. I understand CBO will complete that analysis by early March.

Last week, we took the President's budget to the country, beyond the Beltway. I think it is fair to say that many were dismayed by the President's choices as he attempted to reduce the deficit. Most

agreed with the need to reduce the deficit but did not agree with the priorities of the administration. Cutting sharply again into domestic spending while continuing the Pentagon buildup is a bitter pill for many of the Nation's cities, the rural community and the poor and middle class alike. Some people openly advocated a revenue increase and each stressed the need to cut the deficit in a fair and equitable manner.

Today Dr. Penner is going to tell us how much we must cut the deficit to comply with the Gramm-Rudman targets. I would hope that Dr. Penner would concentrate on several areas of interest to the committee. First, the economic assumptions that underlie the baseline budget projections. We are all concerned that if we are too optimistic now, we could be facing a sequestration order or sequestration vote in September. Second, the policy assumptions that are incorporated in the baseline.

I understand that CBO this year is following a practice advocated by this committee in the past, and is treating defense and nondefense baselines in the same manner. The baseline for each now assumes zero real growth. This seems to me an appropriate change because it levels the playing field for policy decisions on Pentagon and domestic spending. However, we all need to be aware that it also makes CBO's long-term projections of the deficit much more optimistic than in the past.

We should not confuse such changes in methodology with changes in reality, especially while the President continues to propose large real increases in military spending.

Third, the President has not helped us to get an accurate reading of the budget numbers. My staff estimates that defense outlays were underestimated in fiscal year 1987 by some $15 billion. CBO's preliminary estimate was very close to this. I believe $14.7 billion.

I would like Director Penner to explain more fully to the committee why CBO believes the President's budget underestimates defense outlays, which again was reiterated also by the Chair of the Senate Budget Committee, Senator Domenici, this week on national television.

Fourth, I would like Dr. Penner's views on the risk to the economy of the large dose of fiscal restraint contained in this year's Gramm-Rudman target. The deficit will fall from $221 to $144 billion between now and fiscal year 1987. This is a reduction of $77 billion or nearly 2 percent of GNP, a very large reduction in a short time.

What are the consequences of such a reduction? What are the dangers of pushing the economy into a downturn as a result of trying to reach these targets?

I find a number of trouble spots in our economic outlook. The enormous trade deficit, the volatility of the dollar, and our growing foreign indebtedness. I hope Dr. Penner will tell us how he sees these problems playing out over this year and next.

Again, Dr. Penner, we welcome you back to the House Budget Committee and look forward to your testimony. Before we begin, I would like to call upon the ranking minority member, Congresswoman Lynn Martin, for opening comments before we begin your testimony.

Mrs. MARTIN. Welcome, Dr. Penner. Everybody has so many questions they want to ask you, I am just going to say that it is always a pleasure to have you here and we look forward to your statement and I look forward to my questions.

The CHAIRMAN. Dr. Penner, as you know, we will enter your complete testimony in the record. We hope that you will be able to summarize so we can move to questions.

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY EDWARD GRAMLICH, DEPUTY DIRECTOR

Mr. PENNER. Thank you, Mr. Chairman. Before I begin, let me take this opportunity to introduce to the committee, Ned Gramlich, the new Deputy Director of CBO, who comes to us from the University of Michigan. If any of you have hard questions, you can call him up. I am in charge of the easy questions.

The CHAIRMAN. Is that a Gramm-Rudman approach over at CBO? [Laughter.]

Mr. PENNER. It is always a pleasure to appear before this committee to discuss CBO's annual report on the economic and budget outlook. Our economic outlook is quite optimistic. We expect fourth quarter to fourth quarter real economic growth will accelerate from 1985's 2.5 percent to 3.6 percent in 1986, slowing slightly to 3 percent during 1987. Inflation would accelerate very slightly as well, from 3.2 percent in 1985 to 3.9 percent in 1986 and 4.1 percent in 1987. Short term interest rates would decline somewhat in 1986 and remain roughly stable in 1987.

Our optimism is based on a number of factors. The most important of these are: Declining interest rates and soaring financial markets, which should encourage consumer spending and business investment; a falling exchange rate, which should with a timelag halt the deterioration of the trade balance; and falling oil prices, which should add to our real income and counter the inflationary impact of the falling exchange rate.

As always, as you suggested, Mr. Chairman, there are uncertainties in the forecast. In this particular case, although our forecast projects falling oil prices, it uses a somewhat higher price than prevailing today. That's on the positive side. On a more negative note, the credit situation is still worrisome. Thrift institutions continue to fail. The farm credit situation is precarious. The debt of less developed countries remains a major problem. Falling oil prices, while good for the economy on balance, are not good for those holding energy based loans.

In addition, our forecast for business investment is more optimistic than is supported by recent surveys of investment plans. We count on investment plans to move up quickly in the near future.

Given our forecast and economic projections, the baseline budget situation has improved markedly since we last reported in August 1985. It is the first time since I have been at CBO that we have projected declining absolute deficits, although they remain very high relative to most of our fiscal history.

According to our latest estimate, CBO projects a deficit of $208 billion in 1986, which would decline to $181 billion in 1987, and to

$104 billion by 1991. This improvement has led many to think that it will not be as difficult to achieve the targets of the Balanced Budget Act as was believed even a month ago. I, myself, was surprised by the projected deficit for 1987. A word of warning, however, is in order.

The baseline projected in this report differs in several respects from past baselines. It is truly a barebones baseline. First, it reflects the effect of the 1986 sequestration. In other words, the baseline has already been cut once. Second, we have changed our approach to projecting the defense baseline. Defining the defense baseline always raises a number of difficult conceptual issues, especially for weapons systems. These pass through various stages of research, development and testing, through procurement and a series of buys, and finally to needed operation and maintenance costs.

The upshot is that any single year's defense appropriation is part of a multiyear plan. In recent years, therefore, we used the multiyear defense budget authority target in the most recently passed budget resolution to provide our definition of current policy in defense. We did not believe, however, that this definition was appropriate this year. The Balanced Budget Act made the deficit targets in the 1986 resolution obsolete. Moreover, after 1986 appropriations actions and the subsequent sequestration, budget authority for defense came out significantly below the target established by the resolution. Without the resolution for guidance, we decided to project defense budget authority at a constant real level, the same approach taken for most nondefense discretionary programs.

Clearly, however, without any room for real defense growth, this baseline becomes harder to cut than those of the past. The nature of the challenge ahead is illustrated by other numbers. If there were no legislative actions between now and next August and if our forecast and technical assumptions remained constant, our sequestration report would show that an automatic outlay cut would amount to $37 billion compared with our baseline, an amount sufficient to bring total 1987 outlays to $989 billion. This figure is almost exactly equal to the outlay level estimated for 1986 after the first sequestration.

In other word, all COLA's, entitlement caseload growth, defense outlay growth resulting from prior year appropriations, and other inflation adjustments, would have to be paid for by program cuts elsewhere in the budget.

In defense, new budget authority would be limited to $271 billion or $30 billion below CBO's baseline and $49 billion below the administration's budget request.

It is important to emphasize, Mr. Chairman, that these numbers are only illustrative of what might appear in our August report. First, and most obviously our calculations will be averaged with OMB's for that report. Second, legislation and changes in our forecast or technical assumptions can radically change the amount of the required sequestration.

Because across-the-board cuts apply only to slightly more than one-quarter of the total budget, estimating errors are magnified when the percentage across-the-board cuts are calculated. For example, a 1-percent error in estimating outlays, which I regard as a very small error, would amount to $10 billion at today's outlay

level. This converts into a 4.5 percentage point change in the automatic cuts applied in the nondefense area.

In conclusion, Mr. Chairman, in recent years we have made considerable progress in reducing the path of future deficits. Much remains to be done, however, if we are to ease the burden of debt on future generations.

CBO's estimates suggest that the task ahead will be difficult, but the commitment to lower deficits has already improved credit market conditions and the business outlook. That is why CBO feels that it can project a fairly optimistic economic outlook.

Thank you very much, Mr. Chairman. I would be pleased to take your questions.

[Testimony resumes on p. 416.]

[The prepared statement of Mr. Penner follows:]

PREPARED STATEMENT OF RUDOLPH G. PENNER

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the CBO economic and budget projections. These projections are described in detail in the CBO report entitled The Economic and Budget Outlook: Fiscal Years 1987-1991. In my testimony today, I will touch on:

- The economic forecast for 1986 and 1987 and projections for 1988-1991; and
- The CBO baseline budget projection, and how it compares with the CBO projection made last August and with the deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985.

I will conclude with an illustrative calculation of the effects of alternative economic assumptions on the baseline budget estimates.

CBO'S ECONOMIC AND BUDGET PROJECTIONS

The outlook for reducing budget deficits has improved dramatically since last summer, and financial markets have responded with a sharp rally. Although overall economic activity has not yet reacted to these improved financial conditions, the Congressional Budget Office (CBO) expects economic growth to pick up this year.

In 1985, the economy grew at a comparatively low rate of 2.3 percent, well below the substantial gains in the first two calendar years of the current expansion. Growth in productivity came to a halt as employment continued to grow rapidly. The unemployment rate edged down during 1985

and, despite three full years of recovery, the inflation rate remained almost unchanged from the moderate rates attained after the last recession.

Most forecasters, including CBO, anticipate that growth in real gross national product (GNP) will be somewhat faster this year--at about 3½ percent--than it was in 1985. The tremendous rally in financial markets during the second half of 1985 and the sharp decline in the dollar have enhanced the prospects for a pickup in economic activity in 1986. The rise in stock prices and the decline in interest rates will encourage consumer spending and business capital spending, while the decline in the dollar should halt the deterioration in the trade sector. If lower oil prices are sustained, the sharp drop in prices early this year will contribute to growth in economic activity and restrain inflation.

The improvement in financial conditions and the decline in the dollar last year were, at least partially, the result of the dramatic change in the outlook for reducing future budget deficits. The implementation of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177), together with earlier Congressional action, will reverse the recent trend of rising budget deficits. Although a federal district court recently ruled that certain aspects of the Balanced Budget Act are unconstitutional, the deficit targets established by the act still remain in effect. These targets would lower projected deficits from about $208 billion in the current fiscal year to $144 billion in fiscal year 1987, with annual reductions of $36 billion thereafter. The decline in the structural deficit from fiscal year

1986 to 1987 would be about 1.5 percent of potential GNP, the third largest such reduction in fiscal stimulus since the mid-1950s. By itself, such an abrupt shift in fiscal posture could temporarily slow the economic expansion in 1987. But several other factors--including the decline in the dollar, lower interest rates, and the fall in oil prices--are expected to counteract the contractionary effects of the budget shift.

CBO's new baseline budget estimates show much smaller deficits in the 1987-1990 period than the baseline projection of last summer (see Table 1). While the policies of last year's budget resolution were not fully carried out, Congressional action to date has significantly lowered projected defense and nondefense spending. The projected decline in budget deficits under the policy assumptions of the baseline occurs because revenues are projected to grow in response to both inflation and growth in real incomes. At the same time, outlays are projected to grow only slightly faster than the rate of inflation (see Figure 1). The baseline assumes no real growth in defense and nondefense appropriations above a base already cut by the 1986 sequestration called for in the Balanced Budget Act. The additional action needed to comply with the deficit targets amounts to about $37 billion in fiscal year 1987, or $354 billion over the 1987-1991 period.

The sharp decline in long-term interest rates in 1985 seemed to reflect a market expectation of less Treasury borrowing in future years. Sectors of the economy that are interest-sensitive, such as residential construction, already show signs of increased strength. But the major benefit of reduced

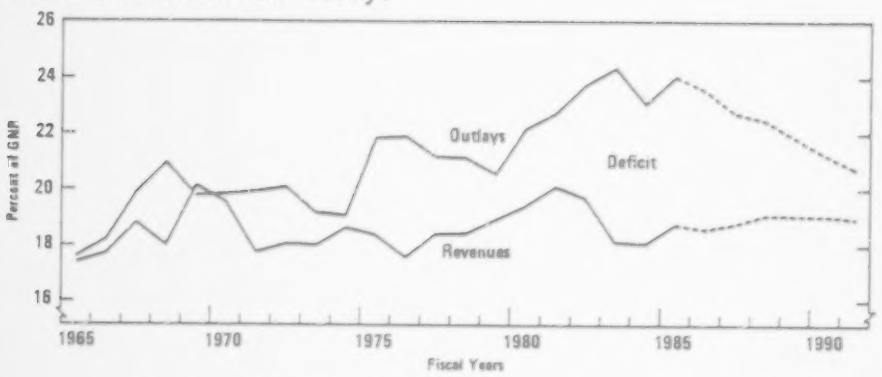
TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1985	1986	1987	1988	1989	1990	1991
Budget Projections (By fiscal year, in billions of dollars)							
Baseline Estimates							
Revenues	734	778	844	921	991	1,068	1,144
Outlays	946	986	1,025	1,086	1,135	1,188	1,248
Deficit	212	208	181	165	144	120	104
Deficit Targets	N.A.	a/	144	108	72	36	0
Baseline Less Targets	N.A.	a/	37	57	72	84	104
Economic Assumptions (By calendar year)							
Nominal GNP, percent change	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP, percent change	2.3	3.2	3.1	3.3	3.5	3.5	3.2
CPI-W, percent change	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate	7.5	6.8	6.7	6.4	6.1	5.7	5.4

SOURCE: Congressional Budget Office
NOTE: N.A. = not applicable.

a. The Balanced Budget Act set a target of $171.9 billion in fiscal year 1986, but limited the sequestration to $11.7 billion. CBO's fiscal 1986 baseline deficit estimate includes the $11.7 billion sequestration, and therefore the $208.3 billion deficit for that year fulfills the act's requirement.

Figure 1.
Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

budget deficits will come, it is generally agreed, in their long-run effects on living standards. Other things being equal, lower deficits should reduce real interest rates and foreign capital inflows, thereby encouraging increased domestic capital formation and reduced foreign indebtedness.

THE ECONOMIC OUTLOOK

The slowing of economic growth in 1985 was largely the result of a reduction in inventory investment. Growth in real final sales was down only slightly from 4.5 percent in 1984 to 4.0 percent in 1985, as weaker household and business spending was partially offset by strengthened government defense purchases and slower deterioration of the trade sector.

At year-end, most indicators began to reflect improving economic conditions. A major exception was net exports, which in December showed sharp further deterioration. But housing starts, retail sales, durable goods orders, employment, capacity utilization, and the overall index of leading indicators all rose sharply. The rally in the stock and bond markets, the decline in the dollar, and the growth of employment are likely to provide a boost to demand in 1986. Moreover, inventories were quite lean at year-end, except for autos, so that increased strength in final sales is likely to be quickly translated into output.

Another development that could have very favorable effects on both inflation and economic growth in the forecast period is the recent drop in oil prices. The CBO forecast was completed in December, before the recent sharp declines. Some decline was assumed in the forecast. By early February, however, short-term futures prices for crude oil were in the $15 to $19 range per barrel--about $6 below the refiners' acquisition cost assumed in CBO's economic projection for mid-1986. Oil prices have been very volatile, however, and some of the decline could be reversed if oil producers agree on a new distribution of output quotas.

The Forecast for 1986 and 1987

The first two years of CBO's baseline economic projections are a "conditional" forecast based on specific policy assumptions:

- The Balanced Budget Act of 1985 is assumed to be fully implemented. The budget deficit is $208.3 billion in fiscal year 1986, well above the $171.9 billion target because the automatic spending cut is limited to $11.7 billion this year. For fiscal year 1987, the forecast assumes that the $144 billion deficit target will be attained.

- The preliminary target ranges for the levels of the narrower monetary aggregates announced last July are assumed to be adjusted somewhat to reflect actual experience through late 1985.

In addition, dollar exchange rates are assumed to decline this year, though less rapidly than in the second half of 1985. Oil prices are assumed to decline about 18 percent from the last quarter of 1985 to mid-1986, and food prices are assumed to rise less than the general price level.

Given these assumptions, CBO expects inflation-adjusted GNP to grow 3.6 percent in 1986 and 3.0 percent in 1987 on a fourth-quarter-to-fourth-quarter basis (see Table 2). The unemployment rate is projected to remain steady at 6.7 percent through calendar year 1987. Inflation is expected to rise gradually in the forecast period. The three-month Treasury bill rate is expected to decline from 7.5 percent in 1985 to 6.7 percent in 1987.

Medium-Term Economic Projections

The projections for 1988-1991 are not a forecast of economic conditions, but assumptions based on average historical experience. Specifically, the growth rate for real GNP from the fourth quarter of 1982 to the fourth

TABLE 2. THE CBO FORECAST (Fourth-quarter-to-fourth-quarter growth rates)

	Actual		Projected	
	1984	1985	1986	1987
Nominal GNP	9.0	5.8	7.6	7.2
Real GNP	4.7	2.5	3.6	3.0
GNP Implicit Price Deflator	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5

quarter of 1991 is assumed to equal the average growth rate in the nine-year periods following earlier postwar recessions. These outyear economic assumptions are not predicated on specific budget policies, and may not be consistent with the budget policies now in place. The major characteristics of the 1988-1991 projections are shown in Figure 2.

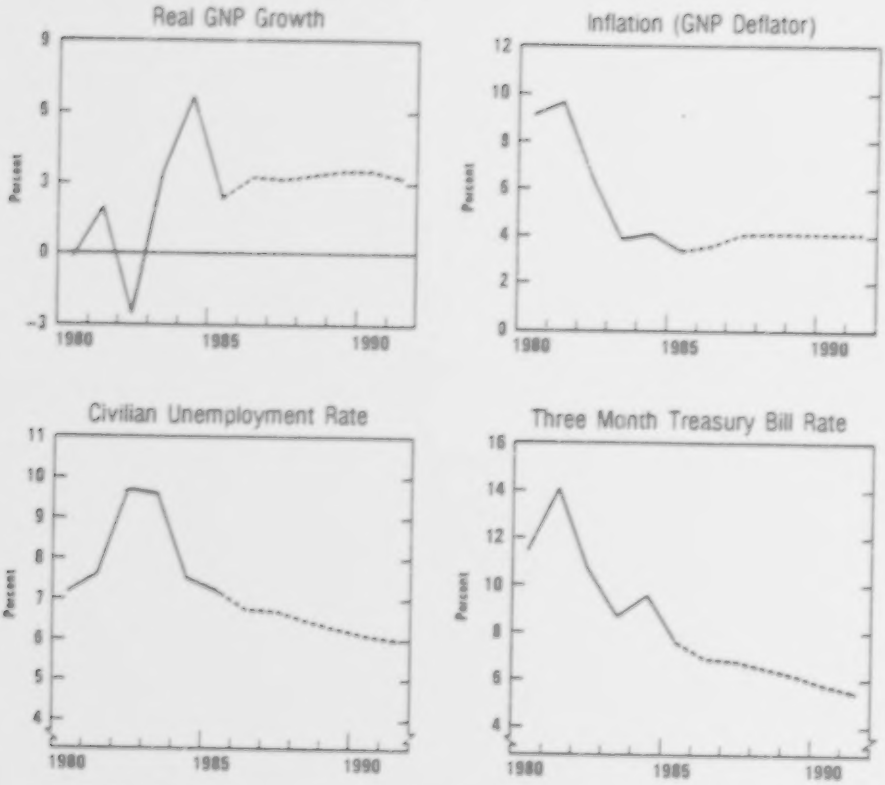
- Real GNP grows moderately at an average rate of approximately 3.4 percent.
- The unemployment rate declines gradually to 6.0 percent by 1991. oInflation, measured by the CPI-W, holds at about 4.3 percent over the projection period.
- Interest rates decline in the outyear projection. The three-month Treasury bill rate, for example, declines from 6.7 percent in 1987 to 5.4 percent in 1991.

Uncertainty in the Outlook

The performance of the economy could easily turn out to be much better or worse than CBO projects. The major uncertainties in the near term are

Figure 2.

Major Economic Assumptions



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

related to oil prices, the trade sector, financial conditions, and federal fiscal policy. Should oil prices remain low, inflation could be significantly lower and real output higher than projected by CBO. The recent decline in interest rates has greatly improved the financial status of many financial

institutions and reduced the debt-service costs of developing countries. But some countries will be made worse off by the drop in oil prices and some financial institutions still suffer from poor-quality loans. For this reason, a financial crisis that would significantly raise risk premiums and interest costs cannot be ruled out.

Both the future course of the dollar and the response of net exports to the dollar's recent fall are difficult to predict. Some forecasters believe that foreign exporters will try to maintain their market shares by reducing profit margins rather than raising prices, thereby causing a delay in the response of U.S. imports to the depreciation of the dollar. Finally, the Balanced Budget Act may not be fully implemented, especially if constitutional challenges to the act are successful. Moreover, exactly how the deficit targets will be met is unclear. These uncertainties make it difficult to predict the short-run economic consequences of the projected turnaround in fiscal policy.

THE BUDGET OUTLOOK

Under CBO's baseline assumptions, which include no real growth in defense or nondefense appropriations, the total federal deficit would fall from $208

billion in 1986 to $181 billion in 1987 and $104 billion in 1991 (see Table 1). The projected decline in baseline deficits parallels the deficit targets in the 1986 budget resolution, but falls increasingly short of the deficit targets in the Balanced Budget Act, which contemplates a zero deficit in 1991.

Over the next five years, revenues are projected to grow on average by 8 percent per year, slightly faster than the assumed average growth of the economy. On the other hand, outlays are projected to rise by an average of 4.8 percent per year, only slightly higher than the assumed rate of inflation. As a result, revenues would remain roughly constant as a percent of GNP, but federal outlays and the deficit would fall, as shown in Figure 1.

The projected decline in budget deficits would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO's baseline assumptions, publicly held federal debt is projected to grow from $1.7 trillion by the end of 1986 to $2.4 trillion by the end of 1991. In relation to GNP, debt held by the public would grow from 41.0 percent in 1986 to a peak of 42.7 percent in 1988 and then decline to 40.2 percent by the end of 1991. Of course, the decline in the debt-to-GNP ratio would be sharper if the Balanced Budget Act is implemented (see Figure 3).

Changes in Baseline Projections

The budget outlook under baseline assumptions has changed dramatically from a year ago. In its 1985 annual report, and again in its update report

Figure 3.

Federal Debt Held by the Public

SOURCES: Congressional Budget Office, Office of Management and Budget, U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1988-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

last August, CBO projected that baseline deficits would rise from slightly more than $200 billion in 1985 to almost $300 billion by 1990. The basic change in the deficit outlook in this report has resulted from lower projections for spending, primarily for defense and nondefense discretionary programs and for net interest costs (see Table 3).

CBO's baseline projections of last year assumed that defense appropriations would increase as specified in the 1985 budget resolution (and extended to 1990), at an average rate of 5½ percent in real terms--after adjustments for projected inflation. The 1986 budget resolution specified

TABLE 3 CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985 (By fiscal year, in billions of dollars)

Major Changes	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
Major Changes:					
Lower defense outlays	-9	-26	-48	-71	-96
Lower nondefense discretionary program outlays	-10	-19	-20	-21	-22
Lower net interest costs	a/	-7	-16	-31	-51
Other outlay changes	6	-4	-4	-8	-12
Lower revenues	9	9	10	11	16
Total changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

a. Less than $500 million.

zero real growth for defense appropriations in 1986 and 3 percent real growth thereafter. Actual 1986 defense appropriations, however, fell short of the budget resolution target, and the 1986 sequestration will reduce the amount of new budget authority even further, to below the 1985 level. CBO's latest baseline projections assume zero real growth in defense appropriations from the 1986 postsequestration level. Because the Balanced Budget Act lowered the outyear deficit targets contained in the 1986 budget

resolution, the assumptions of the resolution can no longer be taken as necessarily representing current Congressional policy. The combination of these factors reduces projected defense outlays by $250 billion for 1986 through 1990 compared with CBO's baseline projections of last August.

Even with 3 percent real growth in defense appropriations in 1987 and beyond, baseline deficits would decline over the next five years, although not as sharply. Instead of baseline deficits declining from $208 billion in 1986 to $104 billion in 1991, they would decline to $150 billion.

The latest baseline projections for nondefense discretionary programs are also lower than those made last year, reflecting reductions made in 1986 appropriations and the effects of the 1986 sequestration. The reduction from CBO's baseline projections of last August is almost $92 billion for the five-year period 1986-1990.

CBO's latest short-term forecast and long-run economic assumptions also feature lower interest rates than were assumed last year. These lower rates, together with a reduction in debt service costs because of other changes, reduce net interest outlays by over $100 billion for 1986-1990 compared with last August's baseline projections. Relatively small changes in baseline deficits result from revised projections for farm price supports and Medicare and other entitlement programs, and from slightly lower projected revenues.

Trends in Federal Spending

Baseline outlays are projected to grow by $262 billion, or 4.8 percent annually, over the 1986-1991 period. Relative to the size of the economy, however, both total spending and all its major components decline. Total outlays fall from 23.5 percent of GNP in 1986 to 20.6 percent of GNP in 1991 (see Table 4). The trends in federal spending are illustrated in Figure 4.

Because the CBO baseline projections assume no real growth in defense budget authority over the 1986 program level, the defense share of GNP hits a maximum of 6.4 percent in 1985 and 1986 and then drops. By 1991, under baseline assumptions, the ratio of defense to GNP would be 5.7 percent--less than in fiscal year 1982.

Spending for entitlement and other mandatory programs is projected to decline from 10.8 percent of GNP in 1986 to 10.0 percent by 1991--about the level of the late 1970s. Nondefense discretionary spending, which already has declined to about the same share of GNP as it represented in 1962, falls further throughout the projections period to 3.4 percent of GNP in 1991.

Because of declining deficits and interest rates (which are predicated on reaching the deficit targets in the Balanced Budget Act), net interest declines from its 1985-1986 peak of 3.3 percent of GNP to 2.7 percent in 1991.

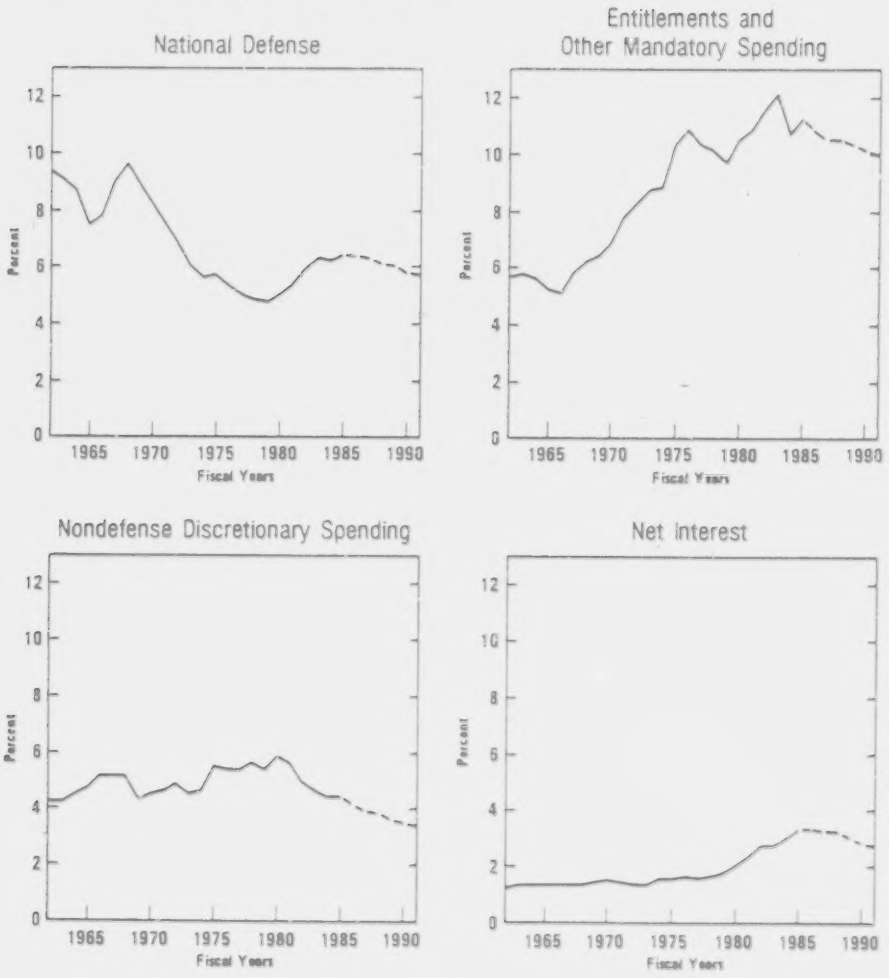
TABLE 4. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1986	1987	1988	1989	1990	1991
In Billions of Dollars						
National Defense	269.5	284.0	296.4	310.9	326.9	343.9
Entitlements and Other Mandatory Spending	453.7	473.6	509.0	536.4	566.5	604.1
Nondefense Discretionary Spending	173.2	174.3	182.6	188.3	195.9	204.0
Net Interest	138.6	145.0	154.4	157.6	159.1	160.3
Offsetting Receipts	-48.8	-51.5	-56.4	-58.4	-60.7	-64.4
Total Outlays	986.1	1025.3	1085.9	1134.9	1187.6	1247.9
Revenues	777.8	844.0	921.0	991.3	1067.5	1143.6
Total Deficit	208.3	181.3	164.9	143.6	120.1	104.3
Debt Held by the Public	1720.1	1900.4	2064.4	2206.9	2326.1	2429.4
As A Percent of GNP						
National Defense	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and Other Mandatory Spending	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense Discretionary Spending	4.1	3.9	3.8	3.6	3.5	3.4
Net Interest	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting Receipts	-1.2	-1.1	-1.2	-1.1	-1.1	-1.1
Total Outlays	23.5	22.8	22.4	21.8	21.1	20.6
Revenues	18.6	18.7	19.0	19.0	19.0	18.9
Total Deficit	5.0	4.0	3.4	2.8	2.1	1.7
Debt Held by the Public	41.0	42.2	42.7	42.3	41.4	40.2
Memorandum: GNP	4192	4504	4838	5214	5619	6047

SOURCE: Congressional Budget Office.

Figure 4.

Outlays by Category as Percents of GNP



SOURCE: Congressional Budget Office.

Alternative Projections

To show how changes in economic assumptions can affect budgetary outcomes, CBO has prepared two alternative sets of projections (see Table 5). They are intended to illustrate what could happen if economic growth turns out to be higher or lower than projected over the next six years.

TABLE 5. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

SOURCE: Congressional Budget Office.

The high path assumes growth almost equal to that of the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in an average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, unemployment falls to 4.6 percent in 1991, while the inflation rate more than doubles. Interest rates also rise sharply after 1988, paralleling the higher inflation rate. Interest rates also rise sharply after 1988, paralleling the higher inflation rate.

The low path incorporates a recession starting in 1987, which has the depth and duration of the 1973-1975 recession, and is followed by an average economic recovery. The weaker growth results in lower inflation and lower interest rates than in the CBO economic assumptions after 1987, and higher unemployment rates.

Under the high-growth economic assumptions, the deficit drops swiftly to near balance by 1990 and a sizable surplus in 1991. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1989, the year following the recession incorporated in the low-growth path, the deficit is more than $125 billion above the CBO baseline projection.

AUTOMATIC SPENDING REDUCTIONS

If the Congress fails to reduce the 1987 deficit to $144 billion before the start of the fiscal year, an automatic procedure could be invoked that would make the reduction by sequestering budgetary resources. Under CBO's February assumptions, a 1987 sequestration would reduce total outlays to $989 billion--$37 billion below the baseline projection. As shown in Table 6, there would be almost no growth in total outlays beyond the 1986 estimated level of $986 billion.

The sequestration procedures under the Balanced Budget Act for 1987 would begin in August 1986 when CBO and the Office of Management and Budget send their initial budget estimates either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this report are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO's projected baseline levels, which include the effects of the 1986 sequestration. The result would be to hold outlays for both defense and nondefense programs to roughly the same levels as estimated for 1986.

TABLE 6. EFFECT OF SEQUESTRATIONS ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
Defense Programs a/		
Presequester baseline levels	275	293
1986 sequester	269	284
1987 sequester	269	266
Nondefense Programs b/		
Presequester baseline levels	618	639
1986 sequester	612	632
1987 sequester	612	615
Net Interest and Undistributed Offsetting Receipts c/		
Presequester baseline levels	105	111
1986 sequester	104	109
1987 sequester	104	107
Total Outlays		
Presequester baseline levels	998	1,043
1986 sequester	986	1,025
1987 sequester	986	989

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.
b. Budget functions 150 through 850, and 920.
c. Budget functions 900 and 950.

To achieve these outlay reductions, defense appropriations for 1987 would have to be reduced 6.2 percent below 1986 postsequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustment for inflation in 1987. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.

The CHAIRMAN. Thank you very much, Dr. Penner.

I would like to just ask a few questions, and the Chair is going to try and keep himself within the 5-minute rule, as well as everybody else. I know that there are many people who would like to ask questions of Dr. Penner.

OMB Director Miller told us that the President's proposed 1987 cuts in domestic spending are small this year because we would only have to cut 5 cents on the dollar, or about 5 to 6 percent from domestic programs, a total of $22.4 billion.

However, isn't this underestimating the cuts somewhat? Because the 1987 spending reductions down to the 1986 sequestration level, have already been assumed in your baseline. Would you say the cuts are small for a program subject to sequestration which also are reduced significantly by the President? Is a 5-percent average in any case a good way to look at this problem?

Mr. PENNER. Strictly speaking, the 5 to 6 percent is correct. Second, you are right to point out that that is on a baseline that has already been cut by sequestration. If we compare it to the pre-sequestration levels, we are talking about roughly an 8-percent average cut in the nondefense programs. That is obviously an average which exempts a lot of programs, on the one hand, and in the President's budget eliminates some others. So, the average may not be all that revealing.

The CHAIRMAN. On the question of the administration's 1987 defense outlay estimates, OMB Director Miller told the committee on Tuesday that the $15 billion difference between CBO and the administration estimates of defense outlays was "not a big difference," and in fact Secretary of the Treasury Baker said the exact same thing. Would you agree?

He also said he hoped I would question you as closely as I did him about the issue. So, let me ask you to explain why CBO believes the President's budget underestimates defense outlays by $14.7 billion. Is it a minor, small issue? Second, how did you come up with your reestimate?

Mr. PENNER. First of all, it should be pointed out that estimating outlays in defense is always difficult, because basically it's hard work spending money, and you have to do a lot of planning, you have to get the bids, you have to sign the contracts, et cetera. So, it is always hard to know how fast that work will be done.

We have sharpened up our estimates a little bit, Mr. Chairman, since I sent you the letter, and now the difference between us is $14.5 billion. It is a very large difference——

The CHAIRMAN. That's a drop of $200 million from your original?

Mr. PENNER. That's right.

The CHAIRMAN. Could you tell me how that difference occurred now, how you went from $14.7 to $14.5 billion?

Mr. PENNER. I think it was simply a more careful look at the trends in the historical spending rates. There is a lot of judgment in this. That has to be emphasized. While there is a lot of judgment, this is a very large difference compared to past history.

In 1983 through 1986, we were always less than $2 billion apart. In 1982, we were $6.5 billion apart at the lower level. So that was a bigger difference.

The main difference between us is that we are basing our estimates on the evidence of past history; that is, on our estimate of the historical spending rates. They, on the other hand, cite a number of reasons why they feel that the historical spending rates are no longer relevant.

We think that we have taken account of most of those reasons. Our estimating difference is mainly in the procurement and research areas, and they are very large, and within those areas, the main part of the difference is in our estimates of how fast the Pentagon will spend from budget authority given them in years before 1986. So that is where the main difference lies, and they have departed from historical rates.

If we used——

The CHAIRMAN. How do you think that they have departed from historical rates? And is there any justification for such a departure?

Mr. PENNER. They give a number of reasons, sir. They're slowing down progress payments. Several of the contractors have been suspended, plus a number of other administrative reasons of that type.

We believe that we have taken account of those. Most of those reasons, or the more important ones, pertain to 1985. So, we do already have some experience with the changes in procedures. I guess they just assign very much more money to those changes than we would.

The CHAIRMAN. You state that the estimates are difficult, but is not $14.5 billion significantly out of line? Do you call that a minor difference or a major difference in light of Gramm-Rudman?

Mr. PENNER. Compared with past history, it is a major difference.

The CHAIRMAN. Would you say it's a major or minor difference in light of Gramm-Rudman's requirements for accuracy and the threat of sequestration?

Mr. PENNER. Well, from the point of view of Gramm-Rudman, of course, you would add that to your base, and it would be divided up—$7½ billion would have to be found in the defense areas, and $7½ billion or so, a little less than that, in the nondefense areas. So that implies a big change in the percentage cuts involved. I think it would be over a 5-percentage-point change.

The CHAIRMAN. And two quick questions. Would you therefore say that the budget that was submitted to us did not reach $143.6 billion?

Mr. PENNER. Well, sir——

The CHAIRMAN. Based on your estimate at this time?

Mr. PENNER. Well, first of all, we will be really taking a very careful look at the entire budget. There will be many estimating differences, and we will be releasing our report on that next Wednesday. So I think we should wait until then to pass judgment. This is a difference involving only the defense part of it. It is a significant difference, as I said, and it is a difference that will approximately hold up when we issue our full report.

The CHAIRMAN. Let me ask it a different way, Dr. Penner. I understand your independent viewpoint, and I don't want to jeopardize that. If all of the other estimates on outlays in other areas hold

up, and this difference—which you say is going to hold up—is still there, would it not put the budget over $144 billion?

Mr. PENNER. Very obviously, sir, it would if that was the only change that we made. There are changes due to economic assumptions we'll be calculating; there are changes due to all sorts of other spending rates of other programs where we will have small differences of opinion. But as far as this program is concerned, we are between $14 and $15 billion higher.

The CHAIRMAN. Therefore, it would put it over if there were no other changes that took place?

Mr. PENNER. If there were no other changes.

The CHAIRMAN. Do you see any closing of the gap between OMB and CBO on this defense outlay underestimate between now and that time?

Mr. PENNER. Between now and next week, sir?

The CHAIRMAN. Between now and next week, or even between now and August.

Mr. PENNER. There won't be any between now and next week, but as we march through 1986 we will, of course, get more actual facts about what the 1986 spend-out rates are, and that will affect both of our estimates, maybe upward, maybe downward. It would be surprising if, come August, we were as far apart as we are now.

I should note, Mr. Chairman, we were $6 billion apart in the prior sequestration report with regard to outlays for 1986.

The CHAIRMAN. Thank you very much, Dr. Penner. Mrs. Martin.

Mrs. MARTIN. Although it may be hard to believe, I am not going to try to get you involved in a partisan squabble. In fact, I am going to try to do something that I hope is useful to all of us on this particular committee and, in fact, even for our colleagues across the Rotunda, regardless of party.

With the compressed schedule of Gramm-Rudman, there are difficulties for all of us. First, I should compliment you and, indeed, everybody who works with you and for you at CBO for the high quality of work, and I know it has been a very difficult time.

As I understand it, normally CBO produces a number of let us say routine reports or analyses, estimates and the like, at the beginning of every year, an analysis of the administration budget, which although not routine is something that has to be done every year, a new baseline, for instance, for the upcoming fiscal year, an analysis of dozens of policy options that impact upon the budget, and so forth. They are all good reports. Some of us actually read them.

But with the new compressed schedule facing members of this committee, we are, I believe, running into a problem. The members of the Budget Committee must have their own options, alternative strategies and, indeed, brilliant ideas ready to go much earlier now in the budget season if they are to have any impact at all on the budget resolution which will be drafted in mid-March. This means, of course, that we need budget cost estimates for options. These options are currently being developed, I am sure, by our Democratic friends, and certainly on our side.

Unfortunately our needs for these estimates go head to head with CBO's already busy beginning-of-the-year schedule. I don't have the solution for this problem. It would be wonderful if you

could get your routine work produced still earlier so that you would be free to give our requests a quick turn-around.

But I suspect that much of this work, such as analyzing the administration's budget, just can't be accomplished any earlier than it is. And in light of Gramm-Rudman we don't expect you to be adding staffing or that somehow you could work harder, because the hours and time that you and your staff put in are known to us all.

So as far as I can see, we have a problem involving priorities. We cannot have our cake and eat it, too. As members of the committee, together with the Senate Budget Committee, we are going to have to give Rudy Penner and his staff some direction and some priorities so that we as members can be sure that the first attention is going to go to the work that we need to have done to fulfill our commitments under Gramm-Rudman.

Therefore, I have a proposal to just throw around, and I then welcome Rudy Penner's reaction.

I would hope that Chairman Gray and I could form a very small group of members from the committee, from both the House and the Senate, Republicans and Democrats, to meet with Mr. Penner and some of his people, to see if there is some way that the workload can be rearranged so that we can get the assistance from CBO which we need, and which we all need, and even if it doesn't happen for this year, when I think you are going to find the bind very shortly, we would be more ready for next year. And I hope that suggestion, truly meant—not even bipartisan—in a nonpartisan way would meet some reaction from the Democratic side and from you, Dr. Penner.

Mr. PENNER. Well, Congresswoman, we were especially fouled up this year because of the need to first do the sequestration report, which in turn pushed everything back. In future years, the situation will change, because there will be no January sequestration report. That work will instead be done in August.

So I don't anticipate this as being as big a problem next year, as it has been this year for us. Nevertheless, we are accumulating the various plans that people want costed out. We have done a lot of work on the budget options volume that I've talked about. We have assigned numbers to a lot but not all of the options. We did provide to the House committee staff materials which are useful in developing various freeze proposals.

So I think we have a lot of information that's relevant, and by the week after next, we should be able to start costing out these various plans. But in the interim, as I say, I think the House committee staff has a lot of information. The trouble is, it may not exactly suit the specs that you have for particular plans. Similarly, we have a lot of options running around now with numbers attached to them, and they may not exactly suit the specs that you have.

But I think you can get a general idea of the dollar numbers that might be assigned to similar kinds of approaches.

Mrs. MARTIN. I hope you are clear that this is not in any way condemning you or your staff. It's a fact with that sequestration.

But as you point out, when you are ready to cost out specific plans a week and a half from now, that leaves us 5 days to get to

the floor. Now that's a reality we're all going to have to face, and I can demand more time than Congressman Fazio or Congressman Leath, or they can demand, Hey, you've got to do mine first, but I'm just saying, there's a squeeze there that I don't think any of us really looked ahead and saw, and perhaps there's going to be an internal way to help them, so we're not yelling at CBO, which is just sort of an innocent bystander doing what the rules tell them to do.

Mr. LEATH. Would the gentlelady yield?

Mrs. MARTIN. Certainly.

Mr. LEATH. Mr. Penner, when did you say your option book will be ready?

Mr. PENNER. Well, it won't actually be in print until the first week of March, but we do have large parts of it with numbers attached to it.

Mr. LEATH. Are those available to the members?

Mr. PENNER. Yes, we can make those available when they're finished.

Mr. LEATH. I thank you.

The CHAIRMAN. The Chair recognizes the gentleman from North Carolina, Mr. Hefner.

Mr. HEFNER. Thank you, Mr. Chairman.

Mr. Penner, when you were talking about assumptions, did I understand you to say that between now and 1991, your projections for growth never did reach 4 percent; is that right?

Mr. PENNER. That is correct, sir.

Mr. HEFNER. If you used the assumptions, your assumptions for growth, if the administration had used your assumptions under the budget that the President has sent up, what would be the differences?

Mr. PENNER. Well, as I said, in terms of the President's budget proposals, we will be reporting on that next week. We did, however, provide in our annual report an analysis of the OMB baseline and what the administration calls their——

Mr. HEFNER. Pardon me. I may not have made myself clear. If you used your assumptions under the rest of their budget, just substitute your assumptions for the rest of their budget, where would you be? Where would we be?

Mr. PENNER. Well, if you have our annual report available, sir, and look at page 67——

Mr. HEFNER. I guess I want you to do my work for me. You're more articulate than I.

Mr. PENNER. It's table 2-3. The first panel which is called Policy Differences shows what are really differences in the definition of the baseline. I think it's the economic and technical differences that are of interest to you, and the total effect of those is shown in the next panel.

Now I'm not able to break out the growth for you all by itself, but that's an indication of the total. You can see that the effects of the two sets of differences are offsetting, but if you were just looking at economic and technical differences, by 1991, you would add $43.3 billion to this current services deficit estimate.

Mr. HEFNER. One other thing. Some of the former Joint Economic Chiefs got together and had a symposium, and they thought we

were being a bit overambitious under Gramm-Rudman, and they thought it was too stringent, and they thought maybe in 1991 a $100 billion deficit would be more in line with where we could be, rather than a balanced budget. What do you think about that?

Mr. PENNER. I think that's very much a policy judgment that involves a lot of values. I think we all agree that the deficit is a major problem. Certainly the vast majority of economists agree that it is now a problem because it reduces the living standards of future generations below what they would otherwise be. And it is that sort of judgment as to how we should be treating our children and grandchildren, versus treating ourselves that's very important to making the judgment as to what deficit you can aim for.

While an economist can certainly say that deficits so large that they cause the interest bill on the debt to get out of control have to be ruled out, there is no economic theory, or at least no generally agreed to economic theory, that will tell you that in any one year this is exactly and precisely the right deficit to aim for.

I can't help but add, however, that zero is a rather elegant number, and that makes a nice, round target, as it were. How fast you get there, I think, is a matter of judgment. If you were really going very fast, there would be some risk of shocking the economy, much as there is a risk when a drug addict goes cold turkey. You might shock it downward.

In terms of the Gramm-Rudman path, as the chairman pointed out in his introductory remarks, the first shock is the biggest one, going from the $208 billion deficit we estimate this year to about $144 billion. We looked at that very, very carefully, because that is more than 1 percent of the GNP. We do not think that that will cause problems, in our forecast.

After that, the deficit reduction amounts are $36 billion per year, which is quite a bit less than 1 percent of the GNP out there, and I think is really not extremely worrisome.

Mr. HEFNER. So you don't think that taking this amount of money out of the economy—whether it's borrowed money or whatever which is spent in the economy—would have any noticeable effect on the economy overall, or do you do any analysis along those lines?

Mr. PENNER. It will have noticeable effects. There's no doubt about it. Let me give you the standard sort of economist's analysis. Economist disagree over the numbers, but in general they would say the deficit reduction will have a negative shortrun effect with very good longrun effects, as I said before, on our long-term standard of living. I think that would be the consensus view.

We think the marketplace has noticed this commitment to lower deficits, and it has already had some effect on interest rates. So in essence, through expectations working on the marketplace, we've brought forward some of the good long-term effects to offset a shortrun negative effect from suddenly drawing purchasing power out of the economy.

In addition to that, we think we're living in a new world today with the internationalization of the American economy, and we believe—again, this is somewhat more controversial than my earlier remarks about the economists—that there is a very close link between our budget deficit and our trade problem. The budget deficit

pushes up real interest rates, attracting international capital; the exchange rate goes up, and our exporters are put at a competitive disadvantage. We would expect that process to be reversed as you start bringing the deficit down.

So whatever very shortrun negative effect deficit reduction might have on purchasing power would be quickly offset, we think, by a positive effect stemming from the international sector of the economy.

Mr. HEFNER. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Frost.

Mr. FROST. Dr. Penner, I want to ask some related questions following up on what Mr. Hefner just asked.

This year, you are forecasting 3.6 percent growth in GNP, and others are forecasting lower growth. Many of us are worried that if we are too optimistic in our economic assumptions, the deficit will turn out to be higher than you estimate, and we will pay a severe penalty in terms of Gramm-Rudman sequestration.

And there are really two questions, and this is a question that I asked one of the earlier witnesses: Wouldn't this be a good year to be extra conservative in your forecast?

And second, if you miss GNP growth, or if GNP growth is lower by 1.5 percent, below the forecast, as happened in the budget resolution last year, how much would the deficit increase if there's a 1.5 percent gap in the GNP growth?

Mr. PENNER. To answer your first question, let me point out, sir, that we're not very out of line with regard to our forecast. Over a 12-month period, our forecast is only one-tenth of 1 percentage point higher than the so-called Blue Chip consensus for 1986 and for 1987 it is only two-tenths of 1 percent higher.

Mr. FROST. Chase and DRI are considerably lower, though.

Mr. PENNER. Yes; the big econometric model people tend to be among the more pessimistic these days, with the exception of Ray Fair, who is even more optimistic than we are in the short run. But if you take the standard list of all forecasters, including the econometric model-makers, we are, as I said, one-tenth higher in 1986 and two-tenths in 1987.

Now, very obviously, that's quite different from saying that we are not too optimistic. Let me just add, however, that I think if oil prices stay down to current levels, you will probably see the consensus moving up somewhat, and it may leapfrog us.

But still, your point is a very important one. The difficulty that the Balanced Budget Act creates for us is one that I described in my opening statement, and that is that very tiny errors in forecasting get magnified. First of all, half the budget is exempt; and then another quarter or so is subjected to special rules which limit the extent of the cut; so any uncertainty slops over into the remaining portion of the budget, a little over a quarter, that is subject to across-the-board sequestration.

So as I said in my statement, just a 1 percent error in forecasting outlays, or $10 billion—what we used to think of in the old days as a trivial error—converts into a 4.5 percentage point change in the necessary across-the-board sequestration. And obviously it makes a big difference to those programs, whether the sequestration is 4.5

percent or 9 percent. So you are very right to draw attention to the uncertainty of this situation.

Now obviously we are going to have problems of being wrong in either direction. On the one hand, if we come along in August and say, "Sorry, you've got $20 billion more deficit than we expected, and you have to sequester," that's going to be very bad news. It's not going to be really great news either if we come along in August and say, "You didn't have to go through all that pain. You did $20 billion too much."

Mr. FROST. Dr. Penner, my specific question, though, was, if we miss by 1.5 percent on GNP, if we use the 4 percent figure that the administration wants us to use, and it turns out to be 2.5 percent, how much difference is that going to make in the deficit?

Mr. PENNER. Very crudely, using our really rough rules of thumb, which are on page 72 of the report, and if that error starts immediately, a 1 percentage point change in real growth causes a $19 billion change in the deficit. So a 1.5 percentage point change would be about $27 or $28 billion.

Mr. FROST. That's a pretty significant figure, of course, particularly in light of the legal situation that we face, in that if the Supreme Court upholds the lower court's decision, and if the automatic procedure is no longer with us, and we then have 5 days in August meeting jointly with the Senate Budget Committee to come up with legislation that will take care of that difference, that difference of $27 or $30 or $35 billion, and then the House and the Senate would have to pass that legislation, and the President would have to sign it or veto it, and we would have to override that veto if he vetoed it, having an error of that magnitude could case some very, very serious problems, to understate the situation.

Mr. PENNER. Yes, sir; If I could, I'd like to comment, though, on one of your passing remarks where you said, "Isn't this a year that we should be forecasting very conservatively?"

I really don't think so from our point of view. A lot of people have suggested that we should low-ball this forecast one way or another. But I don't think that's a judgment that we at CBO should be making. I think we just have to give you the very best forecast we can. We know there are often errors. But I believe that really if you want to bias your actions one way or another, and if your solution is to be more conservative, then it should be reflected in the budget plan that you create—that is to say, you should, if you are using our forecast, close the deficit by more than the $37 billion from our baseline that we estimate.

Mr. FROST. Mr. Chairman, I know my time has expired. If I may ask one follow up question.

Dr. Penner, if we chose to be more conservative, if we chose to use a smaller GNP growth figure that you are projecting, and we're right up front about why we were doing it, that we think that we need to be cautious this year and concerned about what's going to happen later on in the year in terms of Gramm-Rudman sequestration or the legislative process, what would be your response?

What would you say to the press or to the administration or to anyone who would inquire to you, if Congress chose not to use your estimate but to be more conservative?

Mr. PENNER. There are two ways of being more conservative. You could choose a different forecast that would be within our average forecasting error. An average forecasting error is pretty large, about 1 percentage point a year out. If you are asking whether I would criticize that——

Mr. FROST. That's the question. That's the question.

Mr. PENNER. Very obviously, I would not.

Mr. FROST. So you would not criticize us if we chose to be more conservative? Thank you.

The CHAIRMAN. The gentleman from Minnesota, Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Dr. Penner, I have several questions that are sort of unrelated, so I will try and go through them quickly.

First of all, I would just like to return briefly to the discussion that you had with the chairman about this discrepancy that causes such problems between your estimate and OMB's estimate over defense outlays.

The argument that we heard from Director Miller and from Secretary Baker repeatedly was—after they had gone through discussion of the numbers and how you forecast them and all that stuff—was, they said, that we decide at what rate outlays occur, because we control the purse strings of the Pentagon.

I don't know, and maybe other members of the committee do, but I don't know exactly how much validity there is in that. Are they right? Do Weinberger and Miller together have the ability to dramatically alter the rate of outlays from the Pentagon, if they choose to do so, to alter them from historical patterns?

Mr. PENNER. At present we make no attempt to really control the outlays, once we are past the obligational authority.

Mr. WEBER. But do they have the ability legally and technically to do that, if they choose to?

Mr. PENNER. Technically they would have to set up some very new procedures to do that. It is not easy. They could certainly influence the rate, no doubt about that. But as I pointed out in my response to the chairman, a lot of the difference involves the spend-out rate from budget authority—that is, from budget authority created in previous years, a lot of which has been obligated. If you have contracted for a B-1 bomber and it arrives on your doorstep, you have to write a check for it.

So, there are limits to how much you can control it, but certainly you can influence it. If you just postpone mailing your check for the B-1 bomber—if it comes at the end of the fiscal year for instance—you might be able to put the problem over to the next year.

There are things you could do, but it would take a very specific set of procedures which ha not yet been created, to my knowledge.

Mr. WEBER. Would there be any economic harm in doing those things?

Mr. PENNER. It really would depend on how you did it. If you delayed paying for things that were delivered, of course, then in the future, you'd receive higher bids.

Mr. WEBER. Thank you.

I was struck by one comment that you made, and I'm not sure that—maybe I'm way off base—but you said that investment plans

are coming in below your projections. That's one area where the economic data is coming in more negatively than you had anticipated. Many of us—and this is just a hypothetical—were concerned last year that the impact of the tax reform legislation being on hold throughout the year would be to retard investment plans in this calendar year.

Maybe you can't answer the question, but is there any evidence that uncertainty about the Tax Code, because of uncertainty surrounding tax reform legislation, is having a negative effect on the economy?

Mr. PENNER. I think that's a very hard problem to get at, sir. There was a time I thought we noticed something in the multifamily area, but then later things turned around there. So, I cannot point to any specific bit of evidence that would confirm that point of view, although certainly it can't be excluded.

Mr. WEBER. Do you have an alternative explanation which would account for the more pessimistic showing or negative showing in terms of investment?

Mr. PENNER. I don't. Now we should remember that we are talking rates of change here, and in 1984 we had a full-fledged capital boom with investment at a very high level. Indeed, it was higher than in the typical business recovery. So, even though we don't have a big rate of growth of investment, it's still at a very high level. Even if you believe these surveys of capital spending plans, investment isn't at that low a level.

This is a characteristic of an aging business cycle. As you go on investing, you increase capacity faster than demand is increasing. Obviously that cannot go on forever. It almost inevitably has to slow down. The data, by the way, are given on page 49 of our report with the capital spending plans at the bottom of that page. In any case, we are hoping, indeed we are forecasting, that those plans will get a lot better in response to the recently lower interest rates.

Mr. WEBER. OK. Another somewhat technical question. The administration's budget shows almost a $10 billion reduction in budget authority in the Agriculture Department, agriculture function. A great deal of that is because of the estimates of lower CCC outlays under the current farm bill.

Many of us, in trying to come to grips with what numbers we should realistically use in a fiscal year 1987 budget, have some grave concerns about the reliability of the administration's projection regarding CCC deficiency payments. Have you looked at that number? What do you think about their projections? How far off might it be?

Mr. PENNER. Well——

Mr. WEBER. Realizing it's very difficult to estimate.

Mr. PENNER. Yes, sir; we will have a precise answer for you next Wednesday. Our own estimates of budget authority in the total agricultural function, not just for CCC, go from $31.4 billion in 1986 to $23.8 billion in 1987. So, we too believe that the farm bill will save a lot of money year over year.

Mr. WEBER. But that's about $4 billion above what the administration has estimated; am I correct?

Mr. PENNER. Let's see. I just have to check.

Mr. WEBER. The administration's 1987 estimate on budget authority is $19,583 billion, and you said what, about $23 billion is your estimate?

Mr. PENNER. This is budget authority.

Mr. WEBER. Budget authority, right.

Mr. PENNER. On the outlay side, we have it going from $30.4 to $23.2 billion.

Mr. WEBER. The outlays, the administration estimate is at $19.5 billion.

Mr. PENNER. I guess I would really prefer to postpone a detailed answer to that until next week.

Mr. WEBER. OK. Finally, we talked a bit about economic growth assumptions, and I think you passed over quickly—we spent a lot of time talking about the fact that you may be too optimistic, but you passed over very quickly the prospect that you may be too pessimistic.

Now you indicated very briefly that some of the private surveying firms may be leapfrogging your estimate—I believe that was the word you used—because of the possibility that you have not adequately accounted for what happened with oil prices.

What price of oil do you assume, and would you tell us a little more, what are the chances that indeed your own estimate may be too pessimistic or may be soon rendered too pessimistic?

Mr. PENNER. First of all, we definitely assumed too high an oil price. It had a big fall. We started our forecasting procedure in December. At that time, we had oil prices falling to—this is the refiner's acquisition price—to $23 a barrel. It's still considerably higher than the spot and future prices, which are in the $15 range. But we would expect to see them coming together if the spot market stays where it is.

We had a lot of opportunity to correct for that, but with oil prices changing about $1 a day, sometimes, we thought anything we did we'd be likely to regret the next week. So we did not attempt to update that.

If—and I think you still have to be very uncertain about it—oil prices were to stay down at their current levels, that would be good news. It would lower inflation, and contribute something to real growth.

On the other side, of course, we've received the rather disappointing news this morning that the last quarter of last year's GNP growth has been revised downward. So, that's a bit of bad news that is not taken into account in our forecast, either.

Mr. WEBER. OK. Thank you, Mr. Chairman.

Mr. HEFNER [presiding]. The gentleman's time has expired. The gentlelady from California, Mrs. Boxer.

Mrs. BOXER. Thank you, Mr. Chairman.

Dr. Penner, I am glad you solved the problem for us of the $14 billion gap, because I think that the chairman has tried to make the point to the administration that this difference in outlays in the military spending side of the budget is significant, and I think that you have certainly underscored that today, making the point that since Gramm-Rudman, when you're talking about a $14 billion difference, it's not a minor matter.

I want to talk a little bit about the impacts of falling oil prices so that I can understand a little better. I understand what happens to the economy when the oil price goes down and it's a stimulative effect and it's a good effect, and we have expansion. But what could be some of the adverse impacts? You mentioned them very briefly in your report to us. Could you expand on those? If there was continuing fall, what are the regional impacts in our Nation and the worldwide impacts on the banking community if this continues in a downward trend?

Mr. PENNER. Of course, when I talk about good effects, I am talking about the buyers. They do better with a lower price. Obviously the sellers do not. So in the energy-producing regions of the country, and particularly in the oil-producing regions of the country, this will be a considerable loss.

Beyond that, there is the effect on foreign countries producing oil, especially those that owe our banks a lot of money. That can be a serious problem. I think those are the main factors.

Mrs. BOXER. But would you say, then, on balance if you take the good effects versus the bad, that the regions that would have some problems, say Texas or Louisiana, those areas, that would be offset by the general economy? Would that be your general answer?

Mr. PENNER. Yes; we import, oh, roughly 2 billion barrels of oil a year from other countries, and we gain on all of that.

Mrs. BOXER. Just talking about Mexico for a moment. There has been increasing speculation that the U.S. Government is preparing to assist Mexico in the renegotiation of its foreign debt, and it has been estimated that Mexico may need as much as $9 billion in new financial assistance in 1986. To the extent that the United States plans to assist Mexico in obtaining part of its external financing needs, it would appear that purchasing Mexican oil for the strategic reserve might make some sense. I have authored a bill in that direction, where what we would do is make this a loan, but take it back in oil.

Now do you feel it would be better to do that than just rely solely on Mexican paper as collateral against our assistance? Does that make sense to you?

Mr. PENNER. I think, Congresswoman, I would prefer to think about it a little bit and get back to you for the record on that.

Mrs. BOXER. OK. That's fine.

[The following information was supplied for the record:]

STRATEGIC PETROLEUM RESERVE PURCHASES

The Strategic Petroleum Reserve (SPR) will hold close to 500 million barrels of oil at the end of fiscal year 1986. Current policy calls for continued purchases of petroleum until the reserve reaches 750 million barrels. At current fill rates, the reserve would reach this target after the turn of the century. CBO's baseline projections include about $300 million per year for SPR oil purchases between now and 1991, based on the current fill rate.

In the current fiscal year, virtually all SPR oil is already being purchased from Mexico. In 1986 purchases will total nearly 11 million barrels, or an average of about 30,000 barrels a day. In the absence of long-term contracts, CBO assumes that half of all purchases in 1987 and beyond will be from Mexico. Purchasing entirely from Mexico would increase assumed purchases from that country by about $150 million, while commensurately lowering purchases from other suppliers (including Venezuela and Britain's North Sea producers). Since transport costs from Mexico

are slightly lower, an additional $5 to $10 million savings could result from this source.

Purchases from Mexico could also be increased by accelerating the SPR fill rate. Reaching the 750 million barrel target by 1996, for example, would involve annual outlays averaging about $700 to $800 million. Accelerating the fill rate to an average of 70,000 barrels a day, though, would increase the deficit at a time when the Administration and Congress are seeking to reduce the deficit. In addition, some question the need for further funding. The 500 million barrels that the SPR is projected to contain at the end of 1986 represents about 100 to 125 days worth of imports. In light of declining dependence on imports, abundant supplies, and falling prices, some are already calling for elimination or suspension of further SPR purchases. The President's budget, in fact, proposes to halt SPR oil purchases after this year.

Each $1 decline in the price of a barrel of oil is estimated to reduce Mexico's balance of payments by about $550 million. Government economists currently estimate that Mexico will earn less than half the $13 billion it had expected until recently to collect from petroleum exports this year. Purchasing additional SPR oil from Mexico, while undeniably helpful to that country, would address only a small portion of Mexico's external financing needs.

Mrs. BOXER. With the present collapse in the world oil market, does it make sense to sell the naval petroleum reserves at this time, in your opinion?

Mr. PENNER. Well, we have not studied that issue in any detail. I think when you talk about selling any kind of asset, the ultimate question is whether that particular activity will run better in the private sector. And by run better, I mean more efficiently in the broadest sense. I don't mean just profits, but with regard to any kind of social benefits that the activity may have as well.

I think you have to be very specific, activity by activity, in toting up the pluses and minuses of a sale, and we just haven't done that with the naval petroleum reserve.

Mrs. BOXER. I would look forward to some more answers on that.

[The following material was supplied for the record:]

PROPOSED SALE OF NAVAL PETROLEUM RESERVES

CBO estimates that the proposed sale of the Naval Petroleum Reserves (NPRs) at Elk Hills and Teapot Dome will bring the government approximately $2.4 billion in 1988. By selling the NPRs, the government would lose the income it currently receives from oil sales. These lost receipts would be about $0.8 billion in 1988 and $2.6 billion over the 1988–1991 period. Projections of proceeds from the sale of NPR are sensitive to assumptions about timing and private markets' expectations of oil prices. CBO projects lower proceeds from the sale than does the Administration, both because of later timing (which implies less oil remaining in the reserve) and lower oil price assumptions. These projections are discussed in CBO's publication, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1987" (February 1986).

Declining oil prices do not necessarily imply that this is a bad time for the Federal Government to sell the NPRs. Lower oil prices, while reducing the potential selling price, also reduce the income the government itself would receive from continued NPR operations. Thus the choice between selling and keeping the NPRs does not necessarily depend on oil prices. If oil prices fall even more than markets currently expect, selling the NPRs now could turn out, in hindsight, to be an excellent decision. The opposite would be true, of course, if oil prices fall less than expected. Another important issue is the government's gain or loss of corporate income tax receipts paid by potential buyers of the NPRs. Because CBO has not had the opportunity to analyze these issues fully, it cannot now address other questions—such as possible efficiency advantages of putting NPR into private hands—raised by this proposal.

Mrs. BOXER. One more question. Are you aware that the administration has deferred spending in certain domestic programs? In other words, programs that were already budgeted and the House

passed the appropriate bills, the Senate, and the President signed them into law, and he has deferred spending on certain of these areas on the domestic side up to about $9 billion? CBDG is one example. Is your office aware of these deferrals?

Mr. PENNER. Yes; they have deferred them.

Mrs. BOXER. In terms of the Reagan administration's explanation of its own budget, when they told us that they were cutting x number of dollars from the domestic side, did they take that number from a baseline that included the deferrals of spending? Are you aware of that?

Mr. PENNER. I'm just not sure, Congresswoman.

Mrs. BOXER. I would ask if you would look at that, because I have a hunch that the cuts in domestic spending, Mr. Chairman, that we are being told about, the $22 billion, may be an underestimation, and I would really appreciate knowing this.

Just for your information, Dr. Penner, we have sued the Reagan administration on this issue of deferrals, and it will be interesting to see what the courts decide as far as its constitutionality.

Thank you, Mr. Chairman.

[The following information was supplied for the record:]

SUMMARY OF POLICY CHANGES IN PRESIDENT'S BUDGET

CBO's recent publication, "An Analysis of the President's Budgetary Proposals for Fiscal Year 1987," estimates that the President's budget proposals would reduce nondefense outlays in the aggregate by about $28 billion in 1987. Other deficit reductions would stem from revenue increases, while proposed real growth in defense spending would increase the deficit compared to CBO's baseline. The policy changes in the President's budget are summarized below.

THE ADMINISTRATION'S DEFICIT REDUCTION PROGRAM AS ESTIMATED BY CBO

[By fiscal year, in billions of dollars] [1]

Major program	1987	1988	1989	1990	1991	Cumulative five-year changes
CBO Baseline Deficit	181.3	164.9	143.6	120.1	104.3	
Proposed Changes:						
Revenues	−5.9	−7.1	−8.6	−7.2	−6.5	−35.4
Outlays:						
National Defense	12.7	20.2	25.1	29.6	32.9	120.6
Entitlements and other mandatory spending	−15.2	−20.3	−23.2	−26.7	−30.1	−115.5
Nondefense discretionary spending	−8.7	−16.0	−26.3	−32.7	−40.6	−124.3
Offsetting receipts	−4.1	−7.9	−14.8	−9.1	−9.2	−45.2
Net interest	−0.2	−1.7	−4.4	−7.4	−10.7	−24.4
Subtotal, outlays	−15.6	−25.6	−43.5	−46.3	−57.7	−188.7
Total Policy Changes	−21.6	−32.7	−52.1	−53.6	−64.2	−224.1
President's Budget as estimated by CBO	159.7	132.3	91.4	66.6	40.1	

[1] Includes Social Security revenues and outlays, which are off-budget.

Source: Office of Management and Budget, Congressional Budget Office.

CBO's estimate of domestic savings in the President's budget in 1987 is close to the Administration's own estimate. The Office of Management and Budget estimates that deficit reductions—excluding defense and revenues—total about $29 billion relative to the Administration's current services projections. The relatively small differences between the CBO and Administration estimates of savings stem from a variety of sources, including different estimates of the impact of proposed

legislation, different projections of proceeds from asset sales, minor conceptual differences in the baseline, and so forth.

CBO's estimate of program cuts is not significantly affected by its treatment of deferrals. The vast preponderance of the $23 billion in 1986 deferrals announced to date by the President are only part-year deferrals, or represent routine deferrals for slow-spending programs (such as military construction and Federal Aviation Administration procurement). Only about $2 billion in 1986 deferrals has a net budgetary impact, lowering outlays by about $0.2 billion in 1986 and $0.4 billion in 1987.

Mr. HEFNER. The gentlelady's time has expired. The gentleman from Florida, Mr. MacKay.

Mr. MACKAY. Dr. Penner, I would like to go back to that chart or table 2-3 on page 67 and get back into the projections and baseline differences.

We have a tendency when the numbers come together at the end, in other words, when you arrive at a conclusion that is not too far apart, not to pay a lot of attention to the fact that the assumptions that led to the conclusion are very different. We also have a tendency to assume that where there are differences, if one of you is right then the other will automatically be wrong.

In some of these cases, these do not really offset at all. It is like saying are you going to carry an umbrella or are you going to carry your lunch today. The fact of the matter is they are not alternatives.

I would just like to look at these categories. It seems to me that you have some bizarre combinations, some of which are probable. For instance, if the administration wins the battle about whether they are at 3 percent real growth and whatever we did in July or whatever they are saying, and we go to their number, then we will have spent $47 billion more than if we do what you assume we are going to do.

Mr. PENNER. Let me be very clear, sir. It is not what we assume.

Mr. MACKAY. I understand. I'm sorry. I do not phrase these things delicately enough. From what your policy analysis indicates that we are going to do. If we do that, that is going to maximize the chance that you are right and they are wrong on interest rates, because we are going to have a higher deficit. What we would do is we wouldn't offset the $32.5 billion from the $47.1 billion, we would add the two together. Is there not some logic to that?

Mr. PENNER. Certainly what you said is correct. The numbers shown here are even more complicated than that. The interest bill is a combination of rates and different deficits playing into the problem. I should also point out that in terms of the real interest rate, we are not that different from the administration through the projection period. Indeed, by the end we are marginally lower.

What you see here is the effects—because we have higher inflation, we have higher nominal interest rates.

Mr. MACKAY. I think I understand that. From my standpoint, looking at a comparison of OMB versus CBO, I see that they project out to 1991 that we are going to have a 4-percent interest rate on 3-month T-bills and that defies logic as far as I am concerned, and you project 5.4 percent, and that doesn't defy it quite as much. I am prepared to make those choices.

I am saying the chances of your being right on interest rates are greater if they end up as a result of congressional decisions being

right on defense spending. The two are not offsetting, in fact they are cumulative.

Another assumption would be what if we decide, and this is the most probable result, what if we decide we are going to split the difference on defense spending, so we take half of $47 billion over the years, but we still decide you are right on interest and we decide you are right on the technical difference in national defense, we could still come up with a $72 billion difference between these forecasts.

Mr. PENNER. That difference is very, very sensitive to the assumptions one makes. Indeed, we make no pretense that we can really forecast the world beyond 1987, even 1987 is dubious. The numbers you see beyond 1987 really just illustrate what the world would look like if it performed in a historically average manner. We are careful to say we don't think those projections are precisely consistent with the policies implied by current policy.

One has to be careful along a number of dimensions, but the basic point you are making is a correct one. As you said at the beginning, the fact that our deficits look the same doesn't mean there is great agreement amongst us. There are some very large offsetting differences here.

Mr. MACKAY. I think I understand the rationale for your change in the way you looked at the defense budget authority target and the way you defined current policy. I guess that is what I would say.

Mr. HEFNER. The gentleman's time has expired.

Mr. MACKAY. I think I have identified the fact that I am totally confused and that is all I really wanted to do. Thank you very much. [Laughter.]

Mr. HEFNER. The gentleman's time has expired. The gentleman from Texas, Mr. Boulter.

Mr. BOULTER. Thank you, Mr. Chairman.

Dr. Penner, the President's budget has, I believe, and correct me if I am wrong, several billion dollars worth of deficit reduction in it due to privatization efforts and policy changes. Does the CBO budget have any of those savings or do you always assume current law?

Mr. PENNER. We always assume current law, sir.

Mr. BOULTER. Whatever we might get in the way of those initiatives would be something that you do not have in your budget?

Mr. PENNER. No; that would change our numbers.

Mr. BOULTER. You said earlier, Dr. Penner, that there is a real link between the fiscal deficit and the trade deficit, which I instinctly know to be true. Would you explain that, walk me through that a little bit?

Mr. PENNER. I should say first that not all economists in the world agree with our analysis on this. I think it is becoming more generally accepted, though. Our analysis starts with the proposition that our high budget deficit pushes up interest rates above what they would otherwise be. International capitalists, some of whom are American, looking around the world for the best place to invest, see our higher interest rates, have confidence in our political stability and so on, and move more money here than they would otherwise.

Of course, they need American dollars if they are going to invest here. They go out and buy those American dollars, thus driving up their price. That right away makes it harder for our exporters to compete around the world. It makes it easier for foreigners to compete in our markets, and raises the trade deficit.

Mr. BOULTER. That is a great answer. That is just the way I explained it in my town hall meetings. [Laughter.]

Mr. LOWRY. Do you feel better?

Mr. BOULTER. Yes; I agree with all of that. If we start reducing the fiscal deficit, somehow the value of the dollar comes down and we have perhaps a slowing at least, maybe a sudden slowing of foreign capital. What effect is that going to have on our economy?

Mr. PENNER. I suppose I should first point out that my simple explanation made it sound as if all of these things worked simultaneously, and obviously they don't. There are timelags and all sorts of complications in between.

I would argue that what we have already seen happen to the value of the dollar is somehow related—I don't want to say entirely related, but to some degree related—to the fact that we have better prospects for deficit reduction.

There could be a problem there, if the decline in the dollar, which has been fairly gradual, turned into a rout. In our analysis, it is gradual. In our analysis, the trade balance improves but only with a timelag. It doesn't improve right away. The only hope I can give is that the current deterioration proceeds more slowly at first and then eventually turns into a true improvement in 1987.

Mr. BOULTER. Thank you very much.

Mr. HEFNER. The gentleman's time has expired. The gentleman from South Carolina, Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman. Dr. Penner, we are delighted to have you before the committee this afternoon. I am sure you are delighted to be here.

Give me some idea as you perceive it of the impact in the form of a stimulus to the economy this deficit we are running has.

Mr. PENNER. I believe it has been less over the longer period than the old-fashioned textbooks would lead one to think, because of the growing internationalization of the economy and this linkage of the budget deficit and the trade deficit. While the deficit may have stimulated demand initially during the recovery period, I think that stimulus was offset, with some timelag, by the burgeoning trade deficit.

Again, I want to emphasize this is controversial. The slowing of growth in 1985 had something to do with the trade deficit, which in essence was catching up with the budget deficit.

Mr. DERRICK. Taking them separately, and I realize that is hard to really give an opinion on, taking it by itself without the trade deficit, would you say it does have—I'm not trying to put words in your mouth——

Mr. PENNER. I think the very point I am making is that I don't want to take them separately, that they are linked like Siamese twins so that cutting them apart doesn't do you much good in analyzing the current situation.

Mr. DERRICK. How much does it worry you that we have become a debtor nation in the last few years, the last year or so? Does this give you a great deal of concern?

Mr. PENNER. It wouldn't worry me a bit if it were just a repeat of the 19th century, when we borrowed abroad a great deal but invested those funds in highly productive industries. I don't think that is what is going on now. While foreigners didn't buy our Treasury bonds directly, I think you can say they indirectly provided the capital to finance the deficit, and for the most part the deficit hasn't been very productive. In other words, we are accumulating net debt internationally but not using it to create productive investment the proceeds of which could be used to pay off that debt.

What we are doing is leaving the debt to our children and grandchildren, without the wherewithal to pay it off—thereby reducing their standard of living compared to what it would be otherwise. I am not saying they will necessarily be poorer than us, but they could do a lot better were it not for this debt.

Mr. DERRICK. As we get into Gramm-Rudman and just assuming that we move ahead with it, of course, that deficit is supposedly going to decrease, that together with the article that I guess was in today's New York Times, by Peter Kilgore—I guess it was Stockman that said that he thought we had reached a peak as far as the deficit was concerned, regardless of what the Congress and the administration did, that he saw the deficit declining somewhere in the neighborhood of $20 billion a year over the next several years.

How is that going to play into whatever part this large deficit has as a stimulus? What I am really asking you is the reverse of what I asked you a moment ago.

Mr. PENNER. As you close the deficit, it will have a negative effect on domestic income flows. As I say, I think that will be offset by the closely connected change in the trade deficit. They needn't proceed at exactly the same pace. There may be times when one is a little ahead of the other. I think when you are talking about a $36 billion reduction in the deficit per year, via Gramm-Rudman, in an economy that will over that period far exceed $4 trillion, the concern needn't be very great about these things getting out of phase or there being any great shock to the economy. The main concern comes the first year, when the change is very much greater.

As I said, we are concerned about that. We have looked at it as carefully as we can. The forecast that results from our careful look is still a fairly optimistic forecast.

While there is obviously a risk that we may be wrong on any one of the parameters we used, and may get fooled by timelags and all sorts of other things, our best judgment about the effects is embodied in our economic forecast.

Mr. DERRICK. May I have just one short other question?

Mr. HEFNER. Yes.

Mr. DERRICK. Supposedly, as this deficit goes down and the trade imbalance is corrected somewhat, the interest rates are going to go down as well. Is that a natural——

Mr. PENNER. That is our assumption.

Mr. DERRICK. So therefore, it's going to make our country less attractive to foreign capital, supposedly.

Now, Chairman Volcker was before this committee sometime the first part of last year and in part of his testimony I remember he said that it's not a case of whether it's going to happen; it's when it is going to happen. When these foreign firms start pulling back, the situation we're going to find ourselves in is a dearth of capital together with the tremendous interest payments that we're having to make and so forth. Have you seen anything in the last year that would—what do you see as the natural consequence of all this?

Mr. PENNER. Well, I really think it depends crucially on how it unfolds. I'm not sure exactly when Chairman Volcker was before you but if you go back a year——

Mr. DERRICK. I think it was last February about this time, as I recall.

Mr. PENNER. Well, if you go back a year or back more than that, the deficit situation looked so grim that while international capital markets were helping us finance it, you could very easily imagine a situation in which, even though our interest rates were high, this fiscal policy would make them lose confidence in us as a nation. Or maybe they would fear that instead of solving it in good ways we would try to solve it by printing money or in some other very bad way, and there could be a sudden loss of confidence. Then the dollar could plummet, inflation could shoot up, and the Fed might have to try and defend us by raising real interest rates further.

So you could develop a bad scenario like that very easily. I suppose you still can, but I think there has been a very large——

Mr. DERRICK. I would agree with you that that scenario is not as likely now as we perceived it.

Mr. PENNER. That's exactly my point. I think it's very much less probable today than it was, say, 2 years ago.

Mr. DERRICK. Thank you very much.

Mr. HEFNER. The gentleman's time has expired. The gentleman, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman. Thank you again, Dr. Penner, for spending your time with us. I want to try to understand an answer you just gave to Mr. Derrick on the dangers of the effect of our being a debtor nation. If I understood Secretary Baker yesterday, whom I, like everybody, hold in high regard, I believe he said yesterday that we shouldn't worry about the debtor nation status because we are investing productively with this borrowed money. Now, what did you just say there?

Mr. PENNER. I think that the way to put it is that had this occurred without the budget deficit, for some other reason, we would be investing even more productively and that would give us a bigger capacity to produce in the future.

Mr. LOWRY. Well, what are we doing with this borrowed money that's coming in now, since we do have this $200 billion deficit?

Mr. PENNER. The deficit is absorbing the total sum of that $200 billion or so; the total flow of international and domestic capital.

Mr. LOWRY. We're looking to our grandchildren to pay our credit cards; something that's been discussed earlier, and again, the Gramm-Rudman thing, in most of our opinions, makes it much more important—is this outlay spending and two find administra-

tion witnesses before us have said that the difference in the outlay in defense won't be a problem because we, the administration, will control outlays.

And I'm trying to understand how that happens. How in Defense can you control outlays to that extent; are we not going to pay contracts when due? How are we going to do that for $14 or $15 billion?

Mr. PENNER. As I said before, I think you would have to set up a very special mechanism and set of orders to do it. If that were to occur, we could certainly make some judgment as to its effect on the spendout rate.

Mr. LOWRY. But don't we, if the contractor has performed the job and it's on time—and you do the spendout, are we just not going to pay him? I mean, are we just going to defer that for a month or be slower on making the payment? How would they do that in Defense?

Mr. PENNER. There would be areas in which you couldn't do it but there would be other areas where you could do it by ordering differently. In the manpower area, you can get outlay reductions fairly quickly if you change your procedures.

Mr. LOWRY. How is that?

Mr. PENNER. But there are constraints. Once you obligate yourself to a contract, you've got to pay when the thing is delivered. You can delay a few days, I suppose, or maybe even a week or so, but eventually you have to pay.

Mr. LOWRY. Well, any additional information on that? Because I think this is a question because of Gramm-Rudman that is concerning us.

In your testimony, Dr. Penner, you referred to the recent drop in oil prices as having very favorable effects on both inflation and economic growth. What is the effect on inflation and economic growth of utility rate increases, say by—the gentlemen from Minnesota yesterday said a proposal under the power market, PMI's would increase the rates to some of his constituents $100 a month. With the proposal on changing the contracts on the BPA in the administration proposal, it's a wholesale rate increase of from 10 to 15 percent.

If falling oil prices have a positive effect on inflation and growth, what would be the effect of increased utility rates on the inflation and economic growth?

Mr. PENNER. You have to be very careful of that, sir. The reason that falling oil prices have a good effect on American well-being is that we're a net importer of oil. To the extent the price of imported oil falls, we're net gainers.

With regard to domestic changes in price, if you're a producer you lose and if you're a consumer you gain. So in terms of domestic changes in prices, there are some winners and some losers.

Now, because of the way we calculate the CPI with a fixed basket of goods, any price increase shows up there as an increase in inflation.

Mr. LOWRY. If you are, say, in the aluminum business, or say in the agricultural business and your wholesale rates for electricity go up, or your rates for electricity go up 10 to 15 percent, is that going to have an economic or inflation effect?

Mr. PENNER. Well, it will benefit whoever is selling the electricity. It hurts the buyer and benefits the seller. That's the point I'm trying to make.

Mr. LOWRY. Yes, and I think you make that well. Now if you're in worldwide competition, what would be the economic effects of a 10- to 15-percent increase if you're in the aluminum business?

Mr. PENNER. If you're very energy-intensive and you're competing internationally, obviously anything that increases the price of energy is going to make you less competitive if your competitors' costs haven't increased as well.

Mr. LOWRY. Thank you, Dr. Penner.

Mr. HEFNER. The gentleman's time has expired. The gentleman who has waited so patiently, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman. Dr. Penner, I see here you're estimating that inflation will be 3.9 percent; you didn't try and rework your estimate for the falling oil prices which would obviously benefit consumers.

Mr. PENNER. There was some fall in our inflation estimate, but not enough.

Mr. SMITH. Some fall but not enough; we don't know how long they're going to keep it down. What triggers most of the entitlements as far as a percentage of CPI?

Mr. PENNER. The important number involved is what we call the CPI. The biggest impact is, of course, on the Social Security benefit on one hand and the indexing of our tax brackets on the other. Tax indexing is keyed to the CPIV from one fiscal year to the next.

With regard to Social Security, if the rise is less than 3 percent since the last time they got an increase, then they get zero this time. So that's a discontinuity.

Mr. SMITH. So your estimate now is 3.9 percent and we'd have to actually lose nine-tenths of 1 percent or a little more in order to——

Mr. PENNER. As I said, sir, the relevant index is the CPIW, which for 1986 is 3.5 percent. We have it going up a little less than the——

Mr. SMITH. Oh, OK; I'm just reading from the testimony in the summary there.

OK. Well, potentially then we could see a situation even more rosy, if you want to look at the budget potential, of not having Social Security and the other entitlement programs that are off the table in the Gramm-Rudman brought in where they would have no Social Security cost-of-living adjustment then, right?

Mr. PENNER. Well, I think it's only Social Security that's dependent on the 3-percent figure. For things like food stamps and so on, the 3 percentage points are not that crucial.

Mr. SMITH. Wouldn't make any difference, OK.

Mr. PENNER. Below 3 percent the change would be smaller.

Mr. SMITH. Sure, all right. A couple other thoughts. Trust funds. Now, this is always a fight in the Congress as to whether trust funds are going to be left on the budget or taken off the budget. Obviously, with a surplus in a trust fund it's used to sort of offset and reduce borrowing. Have you looked at what the best thing for the American taxpayer ought to be? Whether we ought to move them off budget and try and quit the funny accounting?

Mr. PENNER. While we at CBO don't take positions on things generally, we do take positions on matters of budget accounting, and we hold the very strong position that trust funds should all be in the budget.

Mr. SMITH. All in the budget, or it should not be taken off. Did you guys come out of the Appropriations Committee—that's their view, too. [Laughter.]

What would be the effect if we were to freeze the budget in this year, everything across the board? What kind of savings would that produce and what kind of deficit would that actually produce?

Mr. PENNER. First of all, as you know, sir, there are a lot of different definitions of freezes.

Mr. SMITH. Amen.

Mr. PENNER. We have done some crude calculations. If you were to freeze the nominal dollar value of the program level in defense, it would save about $5 billion. If you were to freeze nominal new budget authority in defense, it would save about $10 billion. If you freeze all COLA's except in Social Security and means-tested programs, you save about $1 billion. If you freeze all COLA's except Social Security, that's about $2 billion. If you freeze all COLA's that's about $7 billion. If you freeze budget authority with the exception of pay in the nondefense discretionary programs, that's about $3 billion. If you freeze pay as well that adds another $1 billion. Those are crude numbers. I know, sir, that your proposal is one in a rather large queue that we hope to turn to as soon as we finish the analysis of the President's budget next Wednesday, and we'll have better numbers for you at that time.

Mr. SMITH. Well, thank you. One last question since I've still got some time. The real interest rates are at the highest level in history, a lot of people say. Why do you think that the interest rates have stayed at such a high level? Is it the marketplace factoring in, as the Chairman of the Federal Reserve would tell us; that it's the marketplace looking at the potential for renewed inflation? Because if that's the case, then over this last 2 or 3 years, the marketplace has evidently been wrong.

But the interesting thing that I question is the fact that the Fed funds rate, which apparently the prime rate in commercial banking circles certainly follows, is an overnight rate, and so if the market is setting the rates they must be worried about overnight inflation. And I've always been kind of curious as to why we keep the banking system alive by continuing to borrow from those people that are still around at very high rates, or lend them money anyway.

Mr. PENNER. The way we measure real interest rates—and, of course, it's hard to measure real rates at the long end—by just looking at the 3-month T-bill, we can say that real rates have come down very dramatically over the last year or so.

We think the high real rates of the recent past, while not entirely due to the deficit, have had something to do with the deficit. I think at the long end, also, the sluggishness in inflation is bringing inflationary expectations down. These expectations have kept nominal rates higher than they should have been, which has made it appear as if we had very high real rates.

So there are a number of factors involved, but we do think the budget deficit has had something to do with the whole picture, and that the better prospects for the deficit have something to do with the rates coming down. Again, there are a lot of other things going on as well.

I noted that the rate of growth of investment had slowed down. Investment represents a demand for capital. The deficit reduces the supply of capital.

I don't mean to say that the deficit is the only thing affecting interest rates, but I think it has played a role.

Mr. SMITH. Thank you, Dr. Penner. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Thank you, Mr. Chairman.

Dr. Penner, I want to say at the beginning that I think you and your staff deserve an enormous amount of gratitude, because those of us who were very deeply involved in the Gramm-Rudman know that you didn't get a Christmas break. I hope you get one this year. But we do appreciate you, and certainly we understand, as one of the many in this group and probably others who have asked you to cost out things, the problem that you've had. We are very appreciative of the way that you and the staff have tried to assist us through this whole scenario.

When we are estimating revenues and income for the budget, I assume that real GNP growth, the unemployment rate, et cetera, are probably the prime movers for that estimate. But could you give me just a capsulized view of how we estimate revenues?

Mr. PENNER. The first step is, of course, the economic forecast as to the total amount of economic activity. Having estimated that it's important to know how much of the total income being generated is, in fact, taxable. For example, fringe benefits are not taxable, so we have to separate those out.

Once you get to the taxable portion, you then have to know what category of the tax system it falls into—the corporate tax system, the personal income tax system, or the payroll tax system—because each category has a very different rate of taxation attached to it. So we try and figure all that out and apply historical estimates of the effective tax rate to those various tax bases, adjusted for any change in the law. Of course, we now have to consider the indexing of the tax brackets, too.

Mr. LEATH. The thing that prompted the question was a chart that I was looking at the other day and I don't have it in front of me, but I think it was probably a historical data chart out of the President's budget. If my memory serves me correctly—you may know the figure—but for fiscal years 1982, 1983, 1984, and 1985, for example, accumulated actual revenues as opposed to cumulative estimated revenues for those 4 fiscal years I want to say was $329 billion overestimated. That may be off $15 or $20 billion, but in excess of $300 billion in overestimates of revenues for those 4 fiscal years.

I'm just curious as to—and I guess that all goes full circle back to what all of us talk about, economic assumptions, estimates and so forth, when we get into these things. We always get in these partisan arguments or philosophical arguments between ourselves

and the White House about what causes these deficits, and I think one thing that's seldom mentioned is the fact that one of the things that is the big surprise when we get down to 6 or 8 months into the fiscal year, and we say, "Oh, horrors, it's going to be $50 billion more than in the budget resolution." One of the big reasons for that is the overestimation of revenues.

You know, that appears to be a significant amount—at least 30 percent or so of the total deficit we've accumulated in recent years.

Mr. PENNER. Obviously, this is all a matter of estimation. People think that when we estimate the gross national product, we're finished with it. As I just suggested, that's not true at all. You've got to estimate how it's divided up into different shares.

It's interesting to note that this year while we project a lot lower GNP than the administration, we have exactly the same revenues. This means we have a rather big difference of opinion with regard to how the GNP is divided up. We're much more optimistic than they are, if I can call it optimism, about how many dollars of taxes you will get for each dollar of GNP this year.

But to return to your estimating point, if they are right about how many tax dollars you get out of each dollar of GNP, and we're right about the level of GNP, we've got a big problem.

Mr. LEATH. Well, the reason I think that it is important for us to at least have this on the record is that I think the President particularly enjoys pointing the finger down Pennsylvania Avenue toward the Congress and talking about how much we overspent and created those enormous deficits. But we seldom ever hear anybody say, Well, you know, the revenues were off $100 billion in that year. Had we reached your revenue estimates, the deficit would be $112 billion instead of $212 billion.

You can historically look back and recognize the difficulty of estimates. I certainly know that you and your office do as credible and honest a job as you can, and I assume that most people who try to do these things do likewise. It's just a difficult thing, but I think it does lend some degree of credibility to what Congressman Frost was saying and what other members have alluded to. Perhaps it's wise, at a time when, because of Gramm-Rudman we can't get away with numbers, whether they're deliberately phony or whether they end up being off, it makes fairly eminent good sense to me that we be somewhat conservative in some of these estimates, particularly as far as revenues are concerned, when we start working on the budget.

Thank you very much, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Georgia, Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

Dr. Penner, I want to ask a couple of questions on the trade figures. Ambassador Yeutter, before the Trade Subcommittee this morning, and also Secretary Baker yesterday, indicated that they anticipate and forecast some leveling out of the trade deficit, particularly during the latter part of this year. In response to an inquiry from me, Mr. Yeutter indicated that he was somewhat concerned that the drop in the value of the dollar over the past few months was probably being absorbed in Japan by a reduction in profits. Therefore we had not yet reached the point that it was

having a great deal of effect on the trade deficit with Japan. And I think that's about a $50 billion figure.

Assuming that Japan takes steps itself, which they appear to be doing, to help the smaller and medium-sized businesses engaged in exporting, so as to maintain their present share in the American marketplace, then we should anticipate continued trade deficits of roughly the same level for this year and next year as well. What effect, if any, will that have on the forecast that you've made here?

Mr. PENNER. Well, there are a lot of elements of the forces that you've described in our forecast. That is to say, we agree not only with Japan but with other countries that prices didn't fully adjust to the big run-up in the value of the dollar more than a year ago.

We agree that in some instances there's a cushion, if I can call it that, in the profit margin, which delays the response. I would say that's only true in some instances, but it couldn't possibly be true everywhere; there will always be a considerable response at the margin.

But those things do delay the adjustment to exchange rate changes. And even without those things, there would be a timelag. The first thing that happens when the dollar's value falls is that our export prices go down, and what we pay for imports goes up. It takes us awhile to change the quantities that we buy and sell, for all sorts of reasons—long-term contracts, sluggishness in behavior, and so on.

So the very first thing that happens when you have a fall in the exchange rate is actually a worsening of your trade balance. After some time, we expect those things to turn around, and that, indeed, is what happens in our forecast. The trade balance continues to worsen for awhile. It worsens in money terms longer than it worsens in real terms—that is to say, the real goods and services bought and sold start to move in our favor more quickly than their values.

Mr. JENKINS. I'm looking at a table in your report, page 26, and if I am reading this correctly, in industrial production for 1984, 11.5—is that an 11.5-percent increase over the previous year?

Mr. PENNER. I'm sorry, sir. You're looking at industrial production?

Mr. JENKINS. Yes.

Mr. PENNER. Yes; that's a 1-percent increase.

Mr. JENKINS. Over the previous year?

Mr. PENNER. That is correct.

Mr. JENKINS. So in 1985, it went from an 11.5-percent increase in 1984 to a 2.2-percent increase?

Mr. PENNER. That is correct.

Mr. JENKINS. Apparently that includes a sharp reduction in everything except defense. If I'm reading this correctly—consumer durables are down from 14 to 0.2 percent?

Mr. PENNER. Oh, I see what you're saying, yes.

Mr. JENKINS. With the expansion in employment, where are most of the jobs being created, because we're not increasing industrial production?

Mr. PENNER. The service industries have been creating an enormous number of jobs over the last period during this economic expansion.

Mr. JENKINS. So most of the increase obviously has to come from the service side of the ledger according to these figures.

Mr. PENNER. That is what's happened in the past, yes. There are signs now, I think, that manufacturing is turning around somewhat.

Mr. JENKINS. That was going to be my next question. Industrial production has turned down in the fourth quarter of 1985. It was actually less than the third quarter of 1985 and less than the first quarter of 1985. Am I reading that correctly?

Mr. PENNER. That is correct. That, of course, covers all sorts of industries. The January number—I wouldn't put a lot of weight on 1 month—was 0.3 percent.

Mr. JENKINS. What I am trying to figure out is, where is the evidence of the turnaround in industrial production?

Mr. PENNER. I guess I should say more accurately we expect some turnaround as our investment goes up. We think that the change in financial markets, both the bond markets and the stock markets, will be quite stimulative over the coming months.

Mr. JENKINS. The fact assumes——

Mr. PENNER. The exchange rate change. While I emphasize the timelags, obviously as it goes on more and more people will benefit in terms of their competitive position.

Mr. JENKINS. That also assumes that the developing countries with the differences in these exchange rates and the problems with their need to export, are able to make their interest payments particularly——

Mr. PENNER. That's right. To the extent that they owe money measured in dollars, the depreciation is very good for them.

Mr. JENKINS. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you. Dr. Penner, I have missed a good deal of your testimony and I apologize. Due to the floods in northern California, my district is floating away at the moment. My State senators keep calling me for money. I don't know where they think they are going to get any in Washington. We may need some supplementals despite everybody's best intentions not to have them.

I was going to ask a number of questions and I am not sure if they have been asked. I would apologize if I ask some that are repetitive.

One of the things that I know a number of us are concerned about is the August surprise, the potential for having misestimated economic growth and thereby less revenues, et cetera.

Do you think there would be some value in having a standby tax available to implement in the event of that sort of situation, something we might have placed in the law triggered by a certain given economic scenario?

Mr. PENNER. As I suggested, if you are concerned more about a negative surprise than a positive surprise, it would be valuable, I think, to do more than you have to do, given the $37 billion discrepancy between our baseline and the target. What form that reserve might take, or how exactly you want to arrange it—I guess I wouldn't presume to give you a recommendation on that.

Mr. FAZIO. If you call it a reserve, you wouldn't necessarily call it revenue. It might be from your perspective some further cut.

Mr. PENNER. It could be on either side of the budget. It could take various forms, I think.

Mr. FAZIO. What would be workable if we were to look at some sort of revenue enhancement? What kind of things could be implemented most readily in that kind of situation, if any?

Mr. PENNER. You are talking about August. I think you have quite a bit of time. I guess maybe we should think of the debate going into October. That gives you a lot of flexibility to choose among the whole array of tax options. Obviously, it is difficult to change taxes like income and corporate profit taxes in the middle of the year even though we sometimes do change them in the middle of the year. The first of the year is more convenient. You would have time under those circumstances. Any kind of excise or energy tax can be changed at any time really.

Mr. FAZIO. Import fee, would that be a relatively easy tax to impose?

Mr. PENNER. I think so. I think the important point is that it can be done any time and is easy to administer if it is not saddled with exemptions.

Mr. FAZIO. Just one other area and you may have touched on it, the sale of assets by the Government. Did we get into that in earlier testimony?

Mr. PENNER. Yes; very briefly.

Mr. FAZIO. I wonder if you could tell us what you feel on both the budget and economic impacts of that? As I understand it, the sale of these assets, a one-time boost to the Treasury, ignores potential long-term income that we derive from these investments that we have made. Even more importantly, perhaps for some people in the short term, it would cause the private sector to go out and borrow money to purchase these assets so they are still being paid off by the Federal taxpayers. It really has very little impact on the overall economic question involved here. In fact, if we are concerned about tightening up available capital and higher interest rates, it certainly may be even neutral. Is that your reading of the situation?

Mr. PENNER. I think you have to differentiate a number of things. Obviously, we need to know the income generated by the asset, in doing our budget estimates. Some people conclude that we should never sell anything that is making a profit. I would disagree with that. In terms of judging whether it is a good idea, I think the crucial issue is whether this asset will operate more efficiently in the public sector or in the private sector.

Mr. FAZIO. That is really the issue, isn't it?

Mr. PENNER. That is the proven issue.

Mr. FAZIO. It should not be seen as a solution or budget deficit problem. It is a matter of approach as to how that function is performed most effectively.

Mr. PENNER. That's exactly right. I think if we did the accounting properly, it would be called a means of financing the deficit as opposed to reducing the deficit. As you suggested, it isn't that much different from selling the stock of a company——

Mr. FAZIO. Trade low interest rate loans that are old for new interest rate loans that are higher probably in most cases, with the hydro project that is 30 years old.

Mr. PENNER. Yes, that is not to say there are not sometimes advantages to doing just that.

Mr. FAZIO. Intellectually, I would agree with you. Politically, you will pardon me if I dissent.

I know that is a subject that the administration has worked extensively on as part of their effort to make our deficit reduction target that much smaller on a one-time basis. Do you think this is the right time to be selling off Teapot Dome and Elk Hills while oil prices plunge to $15 a barrel in the spot market?

Mr. PENNER. Again, I think it really needs a case by case——

Mr. FAZIO. I am asking you about those two cases.

Mr. PENNER. If you think that the oil price is going to be $8, I guess you would want to get rid of them as quickly as you can. But each case has to be looked at very carefully.

Mr. FAZIO. In the context of continuing to fill up the swell.

Mr. PENNER. If the oil price is going to be $20, maybe you should hang onto it. It is a matter of expectations.

Mr. FAZIO. You have not had time to make that kind of analysis obviously, or you would have told me your answer.

Mr. PENNER. We are doing some work on privatization in general—just trying to put the issues more precisely.

Mr. FAZIO. Will you be making that available to us before we finish our deliberations on this budget? Not that we will make the decisions in our resolution, but I think we could certainly benefit from knowing whether we should factor these savings into the budget resolution.

Mr. PENNER. What we are preparing is not a formal study. We have been discussing the possibility of having briefings on it.

Mr. FAZIO. Will you be letting all the members of Budget Committees know, or is this simply for the committees of jurisdiction?

Mr. PENNER. I can be sure to keep in contact on that issue.

Mr. FAZIO. I think the timeliness on this is particularly important. I know you hear that all the time. I am aware as anyone of the burdens that exist on you. We will be talking to you about that in a couple of days in the Appropriations Committee. I am particularly committed to try to get some of these issues, which are relatively new to our budget debate, sorted out early if possible.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

Mr. Penner, under your conservative economic assumptions in your proposal, does the Social Security trust fund get into any trouble between now and 1991, in terms of receipts and outlays?

Mr. PENNER. In the low-growth path?

Mr. SLATTERY. In the low-growth path, what is the annual balances for the Social Security fund? Do you know?

Mr. PENNER. I don't know; I will have to answer that for the record. My guess is it probably doesn't because it is in such good shape these days, but I may be wrong about that. I'll check it.

Mr. SLATTERY. If you would, I would appreciate that.

[The following material was supplied for the record:]

Projections of Social Security Trust Fund Outlays, Incomes, and Balances

The tables below summarize CBO's projections of the income, outlays and balances of the Old-Age and Survivors Insurance (OASI), Disability Insurance (DI), and Hospital Insurance (HI) trust funds under three sets of economic assumptions—CBO baseline, high growth, and low growth. These tables are consistent with the baseline projections that appear in "The Economic and Budget Outlook: Fiscal Years 1987-1991." (Table I-4 in that report compares the key economic variables under each set of assumptions.)

The largest changes from last year's comparable estimates appear, as might be expected, in the HI fund where annual surpluses in the baseline continue to be projected into the 1990s. This is largely the result of the fiscal 1986 freeze of the Prospective Payment System (PPS) rates that significantly lowered the base for future increases. The CBO estimates assume a two percent increase in the PPS rates in 1987 and marketbasket increases thereafter. These differ from the 1985 baseline, where CBO assumed annual increases for fiscal years after 1986 of marketbasket plus one-quarter percentage point.

The outlook for the OASI and DI trust funds, as in the last year's projections, indicates no signs of any financial trouble in the cash benefit programs. Although CBO has raised its estimates of DI spending from last year due to a continued rise in the number of beneficiaries, there are no indications that the program increases we have been observing jeopardize the financial status of the DI trust fund. The OASI fund, under each set of economic assumptions, is expected to experience large and growing annual surpluses over the projection period.

TABLE 1: CURRENT LAW PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES UNDER CBO'S BASELINE SET OF ECONOMIC ASSUMPTIONS

[By fiscal year, in billions of dollars] [1]

	1985	1986	1987	1988	1989	1990	1991
Old Age and Survivors Insurance							
Total outlays	171.6	180.3	191.2	204.8	219.1	234.4	250.7
Income [2]	177.9	181.4	207.2	234.9	257.2	281.9	306.8
Year-end-balance	33.9	35.0	51.0	81.1	119.2	166.7	222.9
Start of year balance, as percent of outlays [3]	22.7	25.5	25.2	31.8	44.3	58.1	73.9
Disability Insurance							
Total outlays	19.4	20.3	21.1	22.2	23.4	24.7	26.1
Income [2]	20.6	22.4	20.1	22.5	24.4	28.9	32.3
Year-end-balance	5.9	8.0	7.0	7.4	8.5	12.6	18.9
Start of year balance, as percent of outlays [3]	28.9	34.7	43.8	37.8	38.1	40.9	56.1
Combined OASI and DI							
Total outlays	191.0	200.6	212.3	227.0	242.5	259.0	276.7
Income [2]	198.5	203.8	227.5	257.5	281.6	310.7	339.1
Year-end-balance	39.7	43.0	58.0	88.5	127.7	179.4	241.7
Start of year balance, as percent of outlays [1]	23.4	26.5	27.0	32.4	43.7	56.5	72.3
Hospital Insurance							
Total outlays	48.7	49.0	53.2	58.9	65.3	72.5	80.5
Income [2]	52.8	67.3	62.3	67.6	72.3	77.7	83.2
Year-end-balance	21.3	39.6	48.7	57.4	64.4	69.6	72.3
Start of year balance, as percent of outlays [3]	35.3	43.4	74.4	82.6	87.9	88.8	86.4
Combined OASI, DI, and HI							
Total outlays	239.7	249.6	265.5	285.9	307.7	331.5	357.2
Income [2]	251.3	271.2	289.6	325.1	353.9	388.4	422.4
Year-end-balance	61.0	82.6	106.7	145.9	192.1	248.9	314.1
Start of year balance, as percent of outlays [3]	25.8	29.8	36.5	42.8	53.1	63.6	75.5

[1] Trust fund income and outlays are based upon the treatment contained in the "Monthly Treasury Statement of Receipts and Outlays of the United States Government." Interest payments on interfund borrowing and on normalized tax transfers are considered as outgo and reimbursements for unnegotiated benefit payments are treated as income. In the projections of the Office of the Actuary of the Social Security Administration, these interest payments are considered as negative income and the reimbursement for uncashed checks is an adjustment to outgo.

[2] Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, certain general fund transfers, and the repayments of interfund borrowing loans.

[3] Start-of-year balances for OASI and DI are computed as the balances at the end of the previous year plus normalized tax transfers at the beginning of the year. Trust fund balances include any borrowed amounts from the other trust funds.

Source: Based on CBO's February 1986 baseline economic assumptions.

Note: Columns may not add due to rounding.

TABLE 2: CURRENT LAW PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES UNDER CBO'S HIGH GROWTH SET OF ECONOMIC ASSUMPTIONS

[By fiscal year, in billions of dollars] [1]

	1985	1986	1987	1988	1989	1990	1991
Old Age and Survivors Insurance							
Total outlays	171.6	180.3	191.1	205.0	220.9	241.9	264.9
Income [2]	177.9	182.0	209.8	241.1	271.3	309.2	355.0
Year-end-balance	33.9	35.6	54.2	90.3	140.7	208.0	298.2
Start of year balance, as percent of outlays [3]	22.7	25.5	25.5	33.4	48.3	65.6	86.7
Disability Insurance							
Total outlays	19.4	20.3	21.1	22.2	23.6	25.5	27.6
Income [2]	20.6	22.5	20.4	23.1	25.7	31.6	37.2
Year-end-balance	5.9	8.0	7.4	8.3	10.4	16.5	26.1
Start of year balance, as percent of outlays [3]	29.6	34.7	44.1	39.3	41.8	47.6	68.1
Combined OASI and DI							
Total outlays	191.0	200.6	212.2	227.3	244.5	267.4	292.5
Income [2]	198.5	204.4	230.2	264.3	297.0	340.8	392.2
Year-end-balance	39.7	43.6	61.6	98.6	151.2	224.5	324.2
Start of year balance, as percent of outlays [3]	23.4	26.5	27.4	34.0	47.7	63.9	85.0
Hospital Insurance							
Total Outlays	48.7	49.0	53.2	59.2	66.8	75.9	87.1
Income [2]	52.8	67.5	62.9	69.0	75.4	83.4	93.1
Year-end-balance	21.3	39.7	49.4	59.3	67.9	75.5	81.5
Start of year balance, as percent of outlays [3]	35.3	43.4	74.6	83.5	88.8	89.6	86.7
Combined OASI, DI, and HI							
Total outlays	239.7	249.6	265.5	286.4	311.2	343.3	379.6
Income [2]	251.3	271.9	293.1	333.3	372.5	424.2	485.3
Year-end-balance	61.0	83.3	111.0	157.9	219.1	300.1	405.8
Start of year balance, as percent of outlays [3]	25.8	29.8	36.9	44.2	56.5	69.6	86.9

[1] Trust fund income and outlays are based upon the treatment contained in "Monthly Treasury Statement of Receipts and Outlays of the United States Government." Interest payments on interfund borrowing and on normalized tax transfers are considered as outgo and reimbursements for unnegotiated benefit payments are treated as income. In the projections of the Office of the Actuary of the Social Security Administration, these interest payments are considered as negative income and the reimbursement for uncashed checks is an adjustment to outgo.

[2] Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, certain general fund transfers, and the repayments of interfund borrowing loans.

[3] Start-of-year balances for OASI and DI are computed as the balances at the end of the previous year plus normalized tax transfers at the beginning of the year. Trust fund balances include any borrowed amounts from the other trust funds.

Source: Based on CBO's February 1986 high growth economic assumptions.

Note: Columns may not add due to rounding.

TABLE 3: CURRENT LAW PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES UNDER CBO'S LOW GROWTH SET OF ECONOMIC ASSUMPTIONS

[By fiscal year, in billions of dollars] [1]

	1985	1986	1987	1988	1989	1990	1991
Old Age and Survivors Insurance							
Total outlays	171.6	180.3	191.4	205.7	220.1	227.9	236.1
Income [2]	177.9	181.0	203.9	221.5	237.9	255.5	270.8
Year-end-balance	33.9	34.6	47.1	62.9	80.7	108.3	143.1
Start of year balance, as percent of outlays [3]	22.7	25.5	24.9	29.5	35.3	42.3	52.9
Disability Insurance							
Total outlays	19.4	20.3	21.1	22.3	23.4	23.9	24.4
Income [2]	20.6	22.4	19.8	21.2	22.6	26.1	28.5
Year-end-balance	5.9	7.9	6.6	5.6	4.7	7.0	11.0
Start of year balance, as percent of outlays [3]	29.6	34.7	43.5	35.5	29.8	26.1	35.7

TABLE 3: CURRENT LAW PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES UNDER CBO'S LOW GROWTH SET OF ECONOMIC ASSUMPTIONS—Continued

[By fiscal year, in billions of dollars] [1]

	1985	1986	1987	1988	1989	1990	1991
Combined OASI and DI							
Total outlays	191.0	200.6	212.5	227.9	243.5	251.8	260.5
Income [2]	198.5	203.4	223.7	242.7	260.5	281.6	299.3
Year-end-balance	39.7	42.5	53.7	68.5	85.5	115.3	154.1
Start of year balance, as percent of outlays [3]	23.4	26.5	26.7	30.0	34.7	40.8	51.3
Hospital Insurance							
Total outlays	48.7	49.0	53.2	58.4	63.8	69.8	76.1
Income [2]	52.8	66.9	60.9	63.6	66.8	70.6	73.7
Year-end-balance	21.3	39.2	46.8	52.0	55.0	55.8	53.4
Start of year balance, as percent of outlays [3]	35.3	43.4	73.6	80.1	81.4	78.8	73.3
Combined OASI, DI, and HI							
Total outlays	239.7	249.6	265.8	286.4	307.3	321.6	336.6
Income [2]	251.3	270.3	284.6	306.3	327.4	352.2	373.0
Year-end-balance	61.0	81.7	100.5	120.4	140.5	171.1	207.5
Start of year balance, as percent of outlays [3]	25.8	29.8	36.1	40.3	44.4	49.0	56.3

[1] Trust fund income and outlays are based upon the treatment contained in the "Monthly Treasury Statement of of Receipts and Outlays of the United States Government." Interest payments on interfund borrowing and on normalized tax transfers are considered as outgo and reimbursements for unnegotiated benefit payments are treated as income. In the projections of the Office of the Actuary of the Social Security Administration, these interest payments are considered as negative income and the reimbursement for uncashed checks is an adjustment to outgo.

[2] Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, certain general fund transfers, and the repayments of interfund borrowing loans.

[3] Start-of-year balance for OASI and DI are computed as the balances at the end of the previous year plus normalized tax transfers at the beginning of the year. Trust fund balances include any borrowed amounts from the other trust funds.

Source: Based on CBO's February 1986 low growth economic assumptions.

Note: Columns may not add due to rounding.

Mr. SLATTERY. Perhaps you have answered this earlier; what are your assumptions with regard to the value of the dollar over the next 2 or 3 years?

Mr. PENNER. We have a declining at a fairly regular but slow rate of a little more than 5 percent this year, year over year, and then almost exactly 5 percent in subsequent years.

Mr. SLATTERY. Perhaps you have already answered this. I am just curious. What is your reaction to the concept of some kind of an energy tax, oil import fee, in light of what is happening to oil prices right now? Maybe you have already answered this earlier.

Mr. PENNER. No, sir; nobody has brought that up. As in all tax matters, we wouldn't have a final conclusion on it. Like all taxes, it has its negatives and positives as opposed to other taxes. I suppose the appealing side of an oil import is twofold. On the one hand, if it directly offsets a price fall, it doesn't shock the consumer in any way. The second appeal is, if you think that in the future oil prices are going to turn around and start to rise, you may want to maintain incentives for conservation in the country. On the downside, it obviously deprives consumers right now of real benefit from the falling oil prices. It raises the inflation rate above what it would otherwise be. It does, that is, unless other countries tax the oil in the same sort of way. Also, it hurts the international trading position of those of our industries that are very energy intensive. They would have an adjustment problem.

I think those are the main points on both sides of that issue.

Mr. SLATTERY. Dr. Penner, with a $4 trillion economy, and this is sort of a hypothetical question, I know, but there is discussion

around here about the need for some kind of additional revenue. I don't think anyone is talking about additional revenue of more than $15 to $20 billion a year, but assuming that was achieved in a combination of energy taxes with some kind of oil import fee, minimum corporate tax, minimum individual tax perhaps, how serious is the threat that a $15 billion tax package would cause our economy serious problems, in light of the $4 trillion economy?

What is the validity to that argument that would have us believe that any kind of tax measure would have a chilling effect on the economy that would be dangerous? Does it make sense, in other words?

Mr. PENNER. I think it really depends on your definitions of words like "serious" and "dangerous." There is no doubt that any tax increase creates inefficiencies in the private sector. Any tax creates disincentives to do various things, some taxes more than others, depending on how they are designed. The only exceptions where a tax increase could actually improve efficiency would be where the tax system has really gone out of whack one way or another.

So, there will be some inefficiency effect in almost any tax increase, but as long as the tax is not too badly designed and is of the kind of magnitude you are talking about, I guess I wouldn't use words like "disaster."

Mr. SLATTERY. Let me ask you it this way; from your perspective, what would be the least dangerous, the least negative tax measures that might be enacted to pick up somewhere in the neighborhood of $15 billion? Or if you can think of any that might have a positive economic effect?

Mr. PENNER. First of all, of course, that is not the only way you judge taxes. You will be very concerned about their distributional effects, which involves a political judgment. If you just focus very narrowly on the economic effects, only on that one consideration, then I think the economist's general rule is that the broader the base of the tax, the better, so that the rate of the tax can be kept as low as possible. It is the rate of tax which creates the disincentives and distortions in the economy.

When you are asking about where our tax system is most inefficient, I think it is in areas where we are now imposing negative tax rates, such as tax shelters and so on, where if the only thing you were concerned about was overall economic efficiency, revenues could be raised relatively efficiently.

Mr. SLATTERY. To sum up what you're saying, sort of basically you are suggesting that any sort of tax with a broad base is the preferred method. Can you be more specific than that? I'm wondering also if you could provide for the record, you know, a specific tax list with some options in terms of——

Mr. PENNER. Yes; we will be doing that within a couple of weeks, and indeed and I believe that we have the numbers on those already. So, we could start making that available.

Mr. SLATTERY. OK. Back to the other question, if you would, for just a second, in terms of—and try to be a little more specific, if you would, Dr. Penner, as far as what kind of tax measures might, in addition to being broad based, might be preferred from the standpoint of providing the least economic disincentive?

Mr. PENNER. Well, as I said——

Mr. SLATTERY. If you are going to talk about raising, you know, $15 to $20 billion, if it was done in the context of the tax reform package that is over in the Senate now, or if it was done in the context of some kind of oil import fee, you know, what is preferred, from an economic standpoint, from your judgment?

Mr. PENNER. As I said, the broader the base, the better. Obviously I'm not considering distributional effects. Something like a very broad-based consumption tax may look very good economically at a low and proportional rate, but one might worry about the distributional effects. In that case you could choose some other less economically efficient tax, but with somewhat different distributional characteristics.

But again, as a general rule, broadening the tax base is the best sort of thing to do. The whole thrust of tax reform is to broaden the base. You can just go down the list of the various individual reforms, which in the context of tax reform are being considered as revenue-neutral elements. The goal is to lower the overall tax rate, but obviously the reforms could be revenue raisers as well. And most of them fall into that general philosophy of base broadening.

Now, people will say to you that most of those reforms have some other goal, too, such as to provide a thrust to a particular industry or particular activities. All of those goals have to be considered, and most of them involve political judgments.

Mr. SLATTERY. OK. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Penner—Mr. MacKay. The Chair recognizes the gentleman from Florida, Mr. MacKay.

Mr. MACKAY. Dr. Penner, I just have this one question that occurred to me while I was looking at these projections, yours and OMB's. It seems to me during say the last 15 or 20 years, every time we get an election year, monetary policy has been accommodated and things have gotten good, and every time we get just past the election year, the screws have been tightened and we have kind of tried to squeeze the excesses out of the system. Why don't we treat that as current policy? [Laughter.]

I mean that's a joke, but where is the reality in these projections? It shows that it's going to be a great year the year of the election, and a great year the year after the election. When are we suddenly going to have an impartial——

Mr. PENNER. Luckily for us, we have a rather precise definition of current policy that we fall back on, and that is the laws currently in place. So we don't have to forecast what has sometimes been called a political business cycle, although I must point out, sir, that if you look at the record, there are almost as many exceptions to that notion of the political cycle as there are instances that prove the rule. It doesn't work very well. Indeed, if you remember, we really tightened up on the money supply in 1979, just to give you one example.

Mr. MACKAY. Well, many of us who were on President Carter's side of that particular year saw that as further evidence of incompetence. [Laughter.]

Well, what I want to know is in your options, will you have an option that shows what you really think would happen?

Mr. PENNER. I'm not sure what you mean by that.

Mr. MACKAY. Well, could I set some assumptions? Could I assume that things are going to be great the year of the election and that that is going to cause some excesses and that inflation is going to crank up again and we got to squeeze it down again, and that it's going to work like it has worked with the exception of the Jimmy Carter year?

Mr. PENNER. Well——

Mr. MACKAY. If I made the assumptions, then could you project——

Mr. PENNER. There were also interesting instances in 1960 and 1976. So, as I say, the exceptions are really——

Mr. MACKAY. Well, we have gotten better at it since then.

Mr. PENNER. Well, sir, to be very serious and very honest about it, it is extraordinarily difficult to cost out different policy options on different sets of economic assumptions. It really is very hard for us. It creates a storage problem in our computers. It creates a possibility of error—for example, if we were to confuse your assumptions with Mr. Slattery's assumptions. It is very easy to do that sort of thing.

So, we really try not to do too much of that. I think as a general matter, in terms of the overall aggregate deficit, you can get a rough idea of the effects of different economic assumptions by looking at the rules of thumb we have published here. We also have two extreme scenarios, one with very good news, and one—our bad news scenario, I guess—with a big recession starting in 1987.

Mr. MACKAY. OK. All right. Thank you very much.

The CHAIRMAN. Dr. Penner, we want to thank you very, very much. You have been, as usual, a very clear and concise witness who has often told us maybe things that we didn't want to hear, but you told it like it is. We want to thank you so much for your being here today, the candor of your testimony, the clarity of it. We look forward to working with you through this budget process as we travel down this new road called Gramm-Rudman together. We will try to make sense of it, and be the pioneers on it. We look forward to your analysis of the President's budget. Let me again commend you on a very important step, with regard to the process, and that is the zero baseline, which you clearly have put in your early analysis. I think that is very important and therefore we are starting out on an even playing field as we look at both domestic as well as Pentagon policy issues. Congress will decide those issues. It's going to be tough within the bounds of trying to reach $144 billion total deficit, but I think this year we have got to have a clear understanding of the baseline issues. We cannot afford to have underestimated outlay expenditures. And I want to thank you very much for the kind of clarity that you have given to this whole budget process here on Capitol Hill.

Mr. PENNER. Thank you very much, Mr. Chairman.

The CHAIRMAN. This hearing stands adjourned.

[Whereupon, at 4:22 p.m., the hearing adjourned until Friday, February 21, 1986.]

IMPACT OF THE PRESIDENT'S 1987 BUDGET

FRIDAY, FEBRUARY 21, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee), presiding.

The CHAIRMAN. The committee will now come to order.

Today, I would like to welcome three well-known economists to the House Budget Committee: Barry Bosworth of The Brookings Institution; Alan Blinder, of Princeton University; and Alan Greenspan, of the Townsend-Greenspan Co. in New York.

We have invited these gentlemen here to discuss the fiscal problem broadly to tell us what impact they think the President's budget will have on our economy and to examine the implications for future years of the Gramm-Rudman deficit targets.

We would especially like to get the panel's view on a number of issues of interest to the committee.

First, I have asked the panel whether the deficit target of $144 billion in fiscal year 1987 is appropriate, given their outlook for economic conditions. Are we cutting too much too quickly, or will the economy revive and thrive on this fiscal policy medicine? More generally, what are the implications for economic stability of fixed deficit targets as required by Gramm-Rudman?

Second, I wonder if the panel would comment on the desirability of a balanced budget in 1991 as the overriding legislated goal of fiscal policy.

Third, I am concerned about the coordination of fiscal and monetary policy under the sharp dose of fiscal restraint that Gramm-Rudman requires.

We will have Federal Reserve Board Chairman Paul Volcker before us next week, but I wonder if the panel could address the question of whether the Fed is likely to be able and willing to offset the contractionary impact of fiscal policy.

Chairman Volcker indicated at the House Banking Committee on Wednesday and in previous statements that he has certain reservations about changing monetary policy in response to Gramm-Rudman.

Fourth, it would be helpful to the committee if you could address the issue of spending cuts versus revenue increases to reduce the deficit. The President clearly feels that any tax increase would slow economic growth while spending cuts would not. What can economics tell us about this?

Finally, I am interested in your views on the economic uncertainties ahead. The trade deficit continues to set records, and we now find ourselves net debtors to the rest of the world.

The dollar has been declining rapidly in recent weeks. Are we in for trouble ahead, or are these conditions of transition to a period of more stable and balanced growth? Does the fall in oil prices brighten the economic outlook, as some would say?

I hope you can tell us how you see the economy performing in the next several years under different policy options.

I would ask each of you to summarize your statements in 10 to 15 minutes so there will be ample time for questions from the committee. Your complete testimony will be entered into the record.

I want to welcome all three of the distinguished witnesses that are here today, and I would like to ask Dr. Greenspan if he would begin. Then I will ask Professor Blinder and Mr. Bosworth to follow in that order.

Dr. Greenspan, welcome to a familiar surrounding for you.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN, INC.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I am delighted to be here, as always, and especially to address the crucial questions which you have raised.

I am going to try to come at the issue in a somewhat general way and then, hopefully, focus a little bit more sharply during the question period on certain of the issues which I will not address in my opening remarks.

I think, first, it is important to recognize that the American economy is exhibiting significant signs of growth at this point. The GNP, as best we can judge, tracking January and halfway through February, is on a track which will produce a 4 percent growth rate during the first quarter.

As has been true for some time, however, the economy has been running essentially in a hand-to-mouth fashion with very short leadtimes for deliveries of materials and supplies, as well as capital equipment. As a consequence, inventories have been drawn down to levels which, in past years, would have created considerable concern on the part of production managers fearful of wildcat strikes or other shutdowns disrupting the exceptionally tight lines of supply. At the moment, however, import-conscious unions have been remarkably quiescent.

The short-term compression in economic decisionmaking is particularly pronounced in the capital goods markets where backlogs for capital equipment remain quite low relative to shipments, and appropriations backlogs for manufacturing corporations suggest very little in the way of longer term commitments.

Only half of orders for equipment have promised delivery leadtimes of more than 6 months. This is an exceptionally low proportion for this category of durable goods in which delivery times are typically fairly long. The dearth of forward commitments also shows up in planned capital expenditures where plans currently on the books, if one were to believe them, imply moderate increases in

real outlays for the first 6 months of this year followed by significant declines.

In short, whatever is to materialize beyond the summer of 1986 is not foreshadowed yet by firm action generating decisions on the part of business management. Since there is very little currently on the books for the later part of 1986, a fairly significant acceleration in new orders and generally expansionary commitment trends must emerge relatively soon merely to assure the 4-percent annual rate of expansion projected by the administration—I say by most economists who have been watching the economic environment in the last several months.

Were it not for the significant improvement in corporate profitability, the decline in long-term interest rates, and the associated rise in stock prices, there would be little in the immediate outlook to suggest the type of acceleration in new orders and appropriations that are required to maintain the economy on the current emerging growth path.

There is an obvious problem with respect to the banking community, and what I don't think yet is fully realized is the types of cuts likely starting to emerge now in exploration and development now amongst oil companies in the United States will be an equivalent of a cut in overall capital expenditures of anywhere between 1 to 1½ percentage numbers, which is a significant number.

To a large extent, the uncertain prospects for capital investment and for the economy as a whole in the period beyond the fall of 1986 revolve around resolution of the budget difficulties and therefore the outlook for long-term interest rates and the cost of capital.

The financial markets are currently assuming, and hence discounting, some favorable resolution of the deficit problem. Should Gramm-Rudman-Hollings prove unconstitutional and be incapable of resurrection through constitutional means, long-term interest rates would rise by a point or more and undercut at least some of the improving growth path.

Clearly, the fall in oil prices will be a major factor since it lowers the basic cost structure. But we are still looking essentially at a forecast for which at the moment, as best one can judge, very little in the way of actions have yet materialized.

However, should the legality of Gramm-Rudman prevail, the tone of the economy by mid-August would allow OMB and CBO to assume for fiscal year 1987 revenues which would imply a budget deficit of less than $190 billion. I am not saying that the deficit, excluding the sequesterings, would, after the fact, prove to be below $190 billion—I do doubt that—but merely that at the point of the determination of sequestering requirements for the fiscal year 1987 budget, that the excess deficit—that is, the amounts over the statutory requirement of $144 billion—would be below $50 billion, and could be significantly below that number.

Such a sequestering requirement which, while severe, would not induce the panicky abandonment of deficit reduction endeavors that might be engendered by $60 or $70 billion required reductions.

This is important since an early success of Gramm-Rudman will reinforce the probability of success at each successive stage. This results from the fact that long-term interest rates—and stock prices by extension—remain excessively high owing to the fear that

future deficits will require the creation of excess money growth by the Federal Reserve.

The associated inflation expectations have become embodied in the long-term interest rates as inflation premiums. To the extent that the markets begin to discount GRH's success and, hence, the expectation of lower deficits in the early 1990's, current inflation premiums built into long-term rates will fall, as indeed they have since the passage of Gramm-Rudman.

But that, in turn, raises the prospect of higher economic growth than currently contemplated and, hence, revenues, as well as reducing outlays tied to lower unemployment. The lower interest rates themselves make a difference. In fact, the decline in rates since the passage of Gramm-Rudman has significantly lowered expected fiscal 1987 interest payments on the Federal debt and, hence, the deficit.

The concern that the so-called fiscal drag induced by the contemplated rapid decline in the deficit is misplaced. The type of deficit reduction program which would place us anywhere near the reduction path envisaged by GRH would be discounted well in advance by the financial markets. The effective demand which would be released by lower long-term interest rates and higher stock prices would surely outstrip the withdrawal of purchasing power contemplated by the reduction in fiscal stimulus.

There is no likelihood of, say, a $100 billion deficit reduction over a 2-year period inducing recession than would its symmetrical equivalent, an increase in the deficit by that amount, create a sustained prosperity. There is no chance of overdoing deficit reduction in today's political environment. Any rate of deficit decline which is even remotely contractionary is not politically contemplatable. The argument which stipulates that the Fed must ease to accommodate any deficit reduction in my judgment misreads how the markets would react.

At any given level of net borrowed reserves, or any other objective measure of Federal Reserve monetary posture, a projected favorable shift in the path of the deficit would reduce today's inflation premiums and, hence, reduce long-term rates without action by the Fed. Arbitrage would immediately bring short-term rates down as well.

I don't understand the current notion that the Fed must ease in advance of the reduction in the actual deficit, or even to ease contemporaneously. In almost all credible scenarios, it is not only unnecessary, but may prove inflationary and, hence, counterproductive.

Obviously, I would not expect the Federal Reserve, when confronted with increased credit demands as a consequence of lower interest rates so to restrict the growth in reserves, as to inhibit any expansion. I would consider the usual partial accommodation of increasing credit demands during an expansionary period to be both proper and desirable. Either to anticipate credit demands or to go beyond moderate accommodation would, in my judgment, be a mistake.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Dr. Greenspan.

Now, at this time, we have Mr. Blinder.

STATEMENT OF ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. BLINDER. Thank you, Mr. Chairman and members of the committee.

In the brief time allotted, I would like to address as many of the questions that you have posed as I can, although I don't think I will be able to touch on them all.

Starting first with the appropriateness of the fiscal year 1987 deficit target of $144 billion, I think that in the abstract, most of us would agree that a $144 billion deficit is too large. But, in appraising a budget target for any particular year, we have to consider where we have been, where we want to go, and how we want to get there.

I don't believe anyone thinks the U.S. economy is suffering from excess demand, so when we talk about raising taxes or cutting spending in order to reduce the deficit, we should, in the next breath, talk about easing up on monetary policy to maintain the growth of aggregate demand.

In my view, what we need today is a change in the policy mix, not a net contraction of aggregate demand coming from the fiscal side. Gramm-Rudman, or the President's budget, provides half of the desired change in the policy mix, the fiscal contraction. But no one, as you know, least of all, Mr. Volcker, has yet guaranteed the other half, the monetary expansion. That puts the economy in a somewhat precarious position.

On a national income and product accounts basis, which is the most appropriate form for appraising macroeconomic impact, this year's deficit is expected to be $54 billion less than last year's, although, as you know, the CBO believes that OMB underestimates defense spending by about $15 billion.

The question is: Is that too much or too little? My own judgment is conditions today are quite ripe for a substantial reduction in the deficit.

First of all, the economy looks strong in the short term, and is therefore well-positioned to withstand some fiscal contraction. Although the administration's standard 4 percent real growth forecast looked rather optimistic a few months ago, recent events in the world oil market make it surprisingly realistic.

Second, indications are that the Federal Reserve System stands ready to ease monetary and credit conditions to compensate for the drop in aggregate demand that a fiscal contraction entails—up to some limit.

The key question here is: How big is that limit? The only way to know for sure is to get the Fed to tell us. But they have been loath to answer such questions directly, or even indirectly. If I have to guess, as I suppose we all must, I would imagine that the Fed will not hesitate to compensate for a $20 to $30 billion deficit reduction package, which is well under 1 percent of GNP.

But I start getting worried about the Fed's willingness to support the economy once the deficit reduction exceeds 1 percent of GNP, about $40 billion. And I have no confidence at all that the Fed would replace the aggregate demand lost to a $60 billion deficit reduction.

As you can see, $54 billion is in my worrisome-to-dubious range. Ironically, $39 billion might be a safer target.

I personally, as I will explain in a moment, favor a somewhat milder deficit reduction path.

Let me make clear that the uncertainty is not about the Fed's ability to compensate for such large cuts in the budget, but about its willingness to do so. A $60 billion cut in spending is about 1½ percent on GNP. With a multiplier of 1½, the net reduction of GNP from a fiscal contraction of this size is about 2.25 percent, which is also a crude estimate of the extra money growth that the Fed would have to provide to stabilize aggregate demand. There is no doubt that the Fed is capable of doing that.

The question is whether it will be willing to do so when monetarists both inside and outside the administration are insisting that money growth rates are too high already, and when real growth may be proceeding at a 4-percent rate. I have my doubts, which is why I feel more comfortable with a smaller deficit reduction, one that puts less of a burden on the Fed.

There is another reason to be dubious about the Fed's actions. Even if Chairman Volcker is determined to maintain total spending in the face of massive budget cuts, the timing is all wrong. Because Gramm-Rudman may or may not be constitutional, and because the President and Congress will be haggling over the budget for some time, the Fed probably will not know until October if the deficit will decline substantially.

Taking action then, of course, would be too late to offset the negative effects on total spending of the fiscal contraction—which would start immediately, if indeed the deficit reduction takes place.

I personally can't imagine the Federal Reserve Board under Paul Volcker actually acting in advance on the hope that the deficit will come down with no guarantee that it actually will.

I must add, however, that all of this guessing has an aura of absurdity about it. As makers of fiscal policy, members of this committee should not be looking upon the Federal Reserve as an inscrutable foreign power whose intentions can be divined only by covert intelligence operations. Fiscal and monetary policy operate on the same economy—our economy—and presumably have similar objectives.

It is high time there was a monetary—fiscal disarmament treaty that recognized this reality. The Fed may enjoy keeping academics like me guessing, and that does little harm. But Members of Congress should not have to guess what the central bank is up to.

The second question you posed has to do with the longer term targets in the Gramm-Rudman-Hollings Act, under which the deficit trails down to zero by fiscal year 1991. The President then wants to inscribe the balanced budget goal in stone, or at least in the Constitution, as if it were one of life's eternal verities.

I have never been able to figure out who it was that decided that a Federal deficit of zero, year-in and year-out measured in the somewhat crazy way we do, is an appropriate is norm for fiscal policy. I am quite sure he was wrong.

First of all, as we know, the budget deficit depends on the state of the economy. The very same spending and tax programs that produce, say, a balanced budget at 6 percent unemployment will

produce a deficit of about $30 billion at 7 percent unemployment. It makes no economic sense to shoot for zero regardless of the state of the economy. I want to come back to that in a moment.

Second, if a balanced government budget is optimal in any sense, it must surely be the combined budget of all levels of government that should be balanced. Where macroeconomic impacts are concerned, it is an irrelevant detail that the Federal Government hands over some of its tax receipts to State and local governments, who then spend it. What matters is total government spending and total government receipts. Recently, all State and local governments combined have been running a surplus of about $60 billion. So, if the balanced budget norm makes any sense at all, it should call for a Federal deficit equal to the State and local surplus.

Third, there is a well-known measurement problem in the Federal budget caused by the fact that the Government does not adhere to the inflation accounting procedures that the Financial Accounting Standards Board recommends for private corporations. In particular, part of what is counted as interest payments in the official budget really just compensates bondholders for their loss of purchasing power to inflation, and is best thought of as an early repayment of principal. This is no trivial matter. By fiscal year 1991, if inflation is still around 4 percent, the overstatement of the deficit will exceed $70 billion, even if we meet the strict Gramm-Rudman targets.

Fourth, it is natural for debt, like everything else, to grow in a growing economy. From 1950 to 1984, mortgage debt grew 2,678 percent; consumer debt grew 2,166 percent; and so on. It would have been strange indeed if Federal debt had been constant.

My point is simply this: We live in a world in which population and all nominal quantities grow bigger each year; so, there is nothing unnatural or pernicious about a growing Federal debt. If we are looking for a norm for the Federal debt, it probably makes more sense to try to keep it constant in real per capita terms, or perhaps relative to GNP, or perhaps relative to other forms of debt.

My own personal preferred budget norm is that we shoot for a balanced budget on an inflation-corrected basis when the economy is at full employment. To me, this norm makes sense as a plausible definition of "neutral" fiscal policy. But, more importantly, it has the sanction of recent history, as table 1 shows.

If you look at table 1 of my prepared testimony, I have put together, based on some earlier CBO numbers, estimates of the budget as percent of GNP, after inflation accounting and on a so-called structural basis. If you look at these numbers, you see the average for the period 1962 to 1982 was to have balance in my concept of the budget.

In the late fifties and into the beginning of the sixties, we had a large surplus by this definition. But in the rest of the sixties throughout the seventies, and in the early 1980's—until the effect of Reaganomics on the budget started to take hold in fiscal year 1983—we were consistently holding to a budget norm to roughly balance the full-employment, inflation-accounted deficit.

I think that was a sensible budget norm. And it is one, as you can see, that we have violated only in the last few years.

This criteria for an appropriate deficit translates to a fiscal year 1989 deficit target of about $72 billion, if 1989 is a full-employment year and inflation is 4 percent. If we are still operating below full employment, the deficit should be commensurately larger.

I was stunned by the fact that this target is exactly equal to the Gramm-Rudman deficit limit for fiscal year 1989. There are two differences, however, and they are both important.

First, I would not then seek to reduce the deficit any further after 1989. Second, the specific numerical target I suggest would, unlike the Gramm-Rudman targets—depend on the state of the economy. If the economy is weaker than expected, the deficit should be larger.

I think I will skip some of this and come to the point to which I have just alluded, the rigidity of the Gramm-Rudman targets, their lack of attention to the state of the economy. I want to come to that because the likelihood that Gramm-Rudman will be declared unconstitutional, it seems to me, gives the Congress a golden opportunity to correct a mistake that it made in December. That mistake was ignoring the fact that the deficit naturally tends to rise and to fall as economic growth falls and rises.

The Gramm-Rudman Act, as you know, sought to fight this natural tendency. So did Herbert Hoover in the 1930's. And in neither case was it a good idea.

Now, I know that Gramm-Rudman has what is sometimes considered an escape clause for recessions. But, first of all, recessions are rarely forecast far in advance by the CBO and the OMB. And even if they are forecast, suspending the Gramm-Rudman deficit limits requires positive congressional action. It is not automatic.

Second, it is not only recessions that matter in this regard. Any slowdown in growth, even if it remains above 1 percent, will lead to higher than expected deficits. In this regard, it is sobering to note that the 5-year projections of the OMB, with all the spending cuts that they assume, still manage to meet the Gramm-Rudman targets only by assuming that this 5-year period will be the greatest period of real economic growth in this country since the late 1960's.

Now, that is possible. But you wouldn't want to bet a lot of money on it. And if we do less well, then the Gramm-Rudman Act will require even deeper cuts than in the OMB's current 5-year projection.

Finally, the real problem with Gramm-Rudman comes when the economy tries to recover from a recession. I fear that the economy's normal recuperative powers would be severely compromised by that legislation, if it remains on the books as it is.

The easiest way to explain that is by an example, and that is why I have concocted table 2, which follows page 11 in the prepared testimony. The numbers here are just approximate, but I think they illustrate the point.

The first two lines are simply taken out of the OMB budget. They are the 5-year projections for the unemployment rate and the deficit, which, as you can see, comply with the Gramm-Rudman targets.

Lines 4 and 5 suppose instead that we have a recession some time, and that the recession begins in 1987 and continues through 1988. If the fiscal year unemployment rate is 7½ percent instead of

the 6½ percent estimated by OMB, the deficit will be about $30 billion higher than they say, with no change in the fiscal program; that is, if the President's 5-year fiscal program, as you read it in the budget, is enacted in toto.

Now, since this higher deficit will come as a surprise, nothing in Gramm-Rudman would prohibit it.

Now we move on to fiscal year 1988, and suppose the recession is still going on and is indeed forecast. So the Gramm-Rudman targets are suspended by Congress while the programs in the President's budget remain intact. If the unemployment rate for that year is 8.8 percent rather than the 6.3 percent now projected, then the deficit will be roughly $80 billion larger than scheduled.

Now, again, that is perfectly legal under Gramm-Rudman, supposing that the Congress has chosen to override it. The hard part of this story comes in fiscal year 1989.

Now, everybody forecasts a recovery, so Gramm-Rudman targets are not suspended. The official deficit limitation for fiscal year 1989 is $72 billion. But the programs contained in the President's budget plan would produce a deficit of about $148 billion if the unemployment rate falls only to 8½ percent, which is a number roughly consistent with 4 percent real growth.

Somehow, somewhere an additional $76 billion in spending cuts will have to be found to comply with Gramm-Rudman. And I don't really see how the economy can recover from a recession in the face of massive spending cuts like that.

The problem is that Gramm-Rudman short-circuits the automatic stabilizing features of the Federal budget. That was a flaw, a serious flaw. But it is a very correctable flaw. If we simply define the targets in terms of the so-called structural deficit instead of the actual deficit, then the automatic stabilizers would be restored.

In the example in this table of fiscal year 1989, a structural deficit limit of $72 billion would correspond to an actual deficit limit of about $154 billion, and therefore no further fiscal contraction would be required. So, if Gramm-Rudman is declared constitutional by the Supreme Court or resurrected in some other way, I cannot overestimate the importance of purging it of this reckless feature.

While a recession does not now appear to be on the horizon, and no one can forecast when one will come, the odds that we will get all the way through 1991 without one are slim indeed. Gramm-Rudman runs the real danger of turning a mild recession into a severe one, or of turning a severe recession into a depression.

Asking Congress to reject legislation that invites a depression is not, it seems, holding it to an unreasonably high standard.

Some of your other questions were addressed in my written testimony, but I think I ought to, in deference to the time, stop there and leave them for the question period.

[Testimony resumes on p. 479.]

[The prepared statement of Mr. Blinder, with attachment, follows:]

Testimony of

Alan S. Blinder

Gordon S. Rentschler Memorial Professor of Economics

Princeton University

Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to testify here today on the macroeconomic aspects of the fiscal 1987 budget and on the longer-term targets set forth in the Balanced Budget and Emergency Deficit Control Act of 1985. Since Gramm-Rudman now seems likely to be ruled unconstitutional, I will assume Congress is no longer bound by those targets and can consider new ones. Your letter of invitation included a long list of questions in which the committee is interested. In the limited time I have, I will try to address as many of them as I can.

1. SHORT-TERM TARGETS: FISCAL YEAR 1987

I would like to begin with the appropriateness of the fiscal 1987 deficit target of $144 billion which is embodied both in

Gramm-Rudman and in the President's budget. In the abstract, most of us would agree that a $144 billion deficit, over 3% of projected GNP, is too large. But, in appraising a budget target for a particular year, we must consider where we have been, where we want to go, and the state of the economy that is supposed to take us there -- as well as the likely course of monetary policy.

I don't think anyone believes that the U.S. economy now suffers from excess demand. So, when we talk about raising taxes or cutting government spending to reduce the deficit, we should, in the next breath, talk about easing up on monetary policy to maintain the growth of aggregate demand. What we need today is a change in the policy mix, not a net contraction of aggregate demand. Gramm-Rudman or the President's budget provides half of the desired change in the policy mix -- the fiscal contraction. But no one, least of all Mr. Volcker, has yet guaranteed the other half -- the monetary expansion. That puts the economy in a precarious position.

On a National Income and Product Accounts (NIPA) basis, which is the most approriate form for appraising macroeconomic impact, this year's deficit is expected to be $193 billion, about the same as in fiscal 1985, while the president's proposed budget for fiscal 1987 has a deficit of $139 billion. Thus the putative deficit reduction is $54 billion, although, as you know, the CBO believes that OMB underestimates defense spending by about $15 billion. If they are right, the deficit reduction is only $39

billion.

Is that too much or too little? My own judgment is that conditions are now ripe for a substantial reduction in the deficit.

* The economy looks strong in the short-term, and is therefore well positioned to withstand some fiscal contraction. Although the administration's standard 4% real growth forecast looked rather optimistic a few months ago, recent events in the world oil market, if they persist, make it surprisingly realistic.

* Indications are that the Federal Reserve System stands ready to ease monetary and credit conditions to compensate for the drop in aggregate demand that a fiscal contraction entails -- up to some limit.

The key question here is: How big is that limit? The only way to know for sure is to get the Fed to tell us. But they have been loath to answer such questions directly. If I have to guess, as I suppose we all must, I would imagine that the Fed will not hesitate to compensate for a $20-$30 billion deficit reduction package -- which is well under 1% of GNP. But I start getting worried about the Fed's willingness to support the economy once the deficit reduction exceeds 1% of GNP -- about $40 billion. And I have no confidence at all that the Fed would replace the aggregate demand lost to, say, a $60 billion deficit reduction. As you can see, $54 billion is in my worrisome-to-dubious range. Ironically, $39 billion might be a safer target; though I

personally favor an even gentler deficit reduction, as I will explain shortly.

Let me make clear that the uncertainty is not about the Fed's ability to compensate for such large cuts in the budget, but about its willingness to do so. A $60 billion cut in spending is about 1 1/2 percent on GNP. With a multiplier of 1 1/2, the net reduction of GNP from a fiscal contraction of this size is about 2.25 percent -- which is also a crude estimate of the extra money growth that the Fed would have to provide to stabilize aggregate demand. The Fed is clearly capable of doing so. The question is whether it will be willing to do so when monetarists both inside and outside the administration are insisting that money growth rates are too high already and when real growth may be proceeding at a 4% rate. I have my doubts, which is why I feel more comfortable with a smaller deficit reduction -- one that puts less of a burden on the Fed. Were I confident that the Fed would not let real growth fall below 2%, I would happily endorse the $54 billion reduction proposed by the president, maybe even more.

There is another reason to be dubious about the Fed's actions. Even if Chairman Volcker is determined to maintain total spending in the face of massive budget cuts, the timing is all wrong. Because Gramm-Rudman may or may not be constitutional, and because the President and Congress will be haggling over the budget for some time, the Fed probably will not know until October if the deficit will decline substantially. But that's too

late. Cuts in government spending affect total spending immediately, but monetary policy affects private spending only with a lag. So, to offset the contractionary effects of fiscal policy in the fall, the Fed would have to start easing up almost immediately -- before it knows what will happen with the budget. Can anyone imagine the Federal Reserve Board under Paul Volcker doing such a thing"

I must add, however, that all this guessing has an aura of absurdity about it. As makers of fiscal policy, members of this committee should not be looking upon the Federal Reserve as an inscrutable foreign power whose intentions can be divined only by covert intelligence operations. Fiscal and monetary policy operate on the same economy -- our economy -- and presumably have similar objectives. It's high time there was a monetary- fiscal disarmament treaty that recognized this reality. The Fed may enjoy keeping academics like me guessing, and that does little harm. But members of Congress should not have to guess what the central bank is up to.

II. LONG-RUN TARGETS: BALANCING THE BUDGET

The Gramm-Rudman-Hollings Act set forth federal deficit targets trailing down to zero by fiscal 1991, and the president's budget outlined a five-year plan to achieve that goal. The president then wants to inscribe the balanced budget goal in stone, or at least in the constitution, as if it were one of life's eternal verities.

I don't know who it was that decided that a federal budget deficit of zero, year in and year out, measured in the odd way that we do, is a sensible norm for policy. But he was wrong. There are many reasons for saying this.

First, the budget deficit depends on the state of the economy. The very same spending and tax programs that produce, say, a balanced budget at 6% unemployment will produce a deficit of about $30 billion at 7% unemployment. It makes no economic sense to shoot for zero regardless of the state of the economy. (This is an important point to which I will return.)

Second, if a balanced government budget is optimal in any sense, it must surely be the combined budget of all levels of government that should be balanced. Where macroeconomic impacts are concerned, it is an irrelevant detail that the federal government hands over some of its tax receipts to state and local governments, who then spend it. What matters is total government spending and total government receipts. Recently, all state and local governments combined have been running a surplus of about $60 billion. So, if the balanced-budget norm makes any sense at all, it should call for a federal deficit equal to the state and local surplus.

Third, there is a well-known measurement problem in the federal budget caused by the fact that the government does not adhere to the inflation accounting procedures that the Financial Accounting Standards Board recommends for private corporations. In particular, part of what is counted as interest payments in

the unified budget really just compensates bond holders for their loss of purchasing power to inflation, and is best thought of as an early repayment of principal. This is no trivial matter. By fiscal 1991, if inflation is still around 4%, the overstatement of the deficit will exceed $70 billion even if we meet the strict Gramm-Rudman targets.

Fourth, it is natural for debt, like everything else, to grow in a growing economy. From 1950 to 1984, mortgage debt grew 2,678%, consumer debt grew 2,166%, and nominal GNP grew 1,209%. Wouldn't it have been strange indeed if federal debt had been constant? My point is simply this. We live in a world in which population and all nominal quantities grow bigger each year; so there is nothing unnatural or pernicious about a growing federal debt. If we are looking for a norm for the federal debt, doesn't it make more sense to try to keep it constant in real per capita terms, or perhaps relative to GNP, or perhaps relative to other forms of debt?

My own preferred budget norm is that we shoot for a balanced budget on an inflation-corrected basis when the economy is at full employment. To me, this norm makes sense as a plausible definition of "neutral" fiscal policy. But, more importantly, it has the sanction of recent history, as Table 1 shows. Here I summarize estimates I have made of the structural, inflation-corrected budget deficit as a percentage of GNP over the period 1956-1987 (fiscal years). You can see that the historical norm over the 1962-1982 period was to have a balanced

TABLE 1
FEDERAL BUDGET DEFICITS: OFFICIAL VERSUS ADJUSTED
(as percent of GNP)

Fiscal year(s)	Official unified budget	Structural, Inflation-adjusted
1962-1982 average	-1.9	+0.05
1956-1961	-0.2	+2.2
1962-1969	-0.9	+0.2
1970-1979	-2.2	-0.1
1980	-2.9	+0.0
1981	-2.7	+0.6
1982	-4.2	-0.1
1983	-6.5	-1.9
1984	-5.2	-2.7
1985	-5.5	-3.5
1986 (OMB projection)	-4.8	-2.9
1987 (OMB projection)	-3.2	-1.4

budget on this definition. Looking at subperiods, we see that fiscal policy was much tighter than this norm in 1956-1961, but conformed rather closely in the rest of the 1960s, in the 1970s, and in the early 1980s. The big departure from balance by this measure started only in fiscal 1983, when the Reagan tax cuts started to have large effects. (Notice, by the way, that the deterioration in the budget is worse by this measure than it is by the conventional measure.)

The criteria I have just suggested translates to a FY89 deficit target of about $72 billion, if 1989 is a full-employment year and inflation is 4%. If we are still operating below full employment, the deficit should be commensurately larger. I was stunned by the fact that this target is exactly equal to the Gramm-Rudman deficit limit for FY89. There are two differences, however, and they are both important. First, I would not then seek to reduce the deficit any further after 1989. Second, the specific numerical target I suggest would -- unlike the Gramm-Rudman targets -- depend on the state of the economy. If the economy is weaker than expected, the deficit should be larger.

Because of the interest savings from reducing the deficit, we can achieve the fiscal 1989 target I suggest by making programmatic cuts that are smaller than the roughly $100 billion budget gap between where we are now and where we want to be in 1989. A rough guess is that $24 billion a year for each of the next three years would suffice. In the BUSINESS WEEK issue of

December 30, 1985, which I append for the record, I advocated a specific plan for doing precisely that. It would:

* raise taxes by $12 per year for three years, using such vehicles as (in order of preference) closing income tax loopholes, raising excise taxes on alcoholic beverages and cigarettes, and perhaps levying new energy taxes.

* trim the growth of the defense budget by about 1.5 percentage points a year for three years; say, 1 1/2% real growth rather than 3%.

* trim the growth of Social Security and Medicare by about 1.5 percentage points a year for three years (though there are undoubtedly better ways to reduce social security expenditures, such as making benefits taxable).

* cut about $4 billion per year for three years out of the portion of the budget that remains after defense, social security, and interest are removed.

This, of course, is far from the only way to cut $24 billion per year from the deficit. Committees of elected representatives like yourselves are supposed to decide on priorities for spending and taxes. I offer these particular numbers only as an example to show that deficit reductions of this magnitude need not cause undue pain, political or otherwise. The president's budget, in my judgment, severely handicaps the deficit reduction process by ruling out any revenue increases, and by exempting defense and social security. That leaves a slender base for deficit reductions. With a broader base, the whole process can go much

smoother.

Before leaving the question of long-run targets, I should note that I am aware of arguments that we should be shooting for steeper deficit reductions -- enough to yield a surplus in the inflation-corrected budget -- as a way of raising national saving. In 1985, net national saving in the United States, including both private saving and government dissaving, was only 3.4% of net national product. That's well below the historical norm for 1951-1983 of 7.4%. As a nation, we should be saving more.

The policy I propose would move the federal deficit, as currently measured, down from about 5.5% of GNP in fiscal 1985 to about 1.5% of GNP in fiscal 1989; my guess is that this would raise the national saving rate by about 3-4 percentage points, putting us back in or near the normal historical range. That strikes me as a reasonable target, especially when you consider the difficulties -- macroeconomic, microeconomic, and political -- of cutting the federal deficit even that much. To try to do more, that is, to actually raise national saving above historical norms, is probably asking too much.

3. THE PROBLEM WITH FIXED DEFICIT TARGETS

The fact that Gramm-Rudman seems very likely to be declared unconstitutional gives us a golden opportunity to rid ourselves of what, from a macroeconomic perspective, was its worst feature: the fact that the deficit targets are set in advance, irrespective of the state of the economy. As I noted a few

minutes ago, the deficit tends to rise and fall as economic growth falls and rises. Gramm-Rudman sought to fight this natural tendency. So did Herbert Hoover. Neither had a good idea.

Yes, I know Gramm-Rudman has what is sometimes considered an escape clause for recessions. But:

(a) recessions are rarely forecast in advance by CBO and OMB. And even if a recession is forecast, suspending the Gramm-Rudman deficit limits requires positive action; it is not automatic.

(b) it is not only recessions that matter. Any slowdown in growth, even if growth remains above 1%, will lead to a higher-than-expected deficit. In this regard, it is sobering to note that the OMB five-year projections, with all their spending cuts, manage to meet the Gramm-Rudman targets only by assuming that the 1986-1991 period will be the greatest five- year period for real economic growth since the late 1960s. It is extremely doubtful that we will do this well. If we do not, Gramm-Rudman would require even deeper cuts in a weaker economy.

(c) the real problem with Gramm-Rudman comes when the economy tries to recover from a recession. I fear that the economy's normal recuperative powers would be severely compromised by that legislation, if it remains on the books. The easiest way to explain the problem is by an example based on OMB's forecast (see Table 2). The numbers I use are approximate, but they illustrate the point.

The first two lines of the table show the OMB forecast for

TABLE 2

GRAMM-RUDMAN AND RECESSIONS: AN EXAMPLE

February OMB forecasts	1986	1987	1988	1989	1990	1991
1. Unemployment rate	6.7	6.5	6.3	6.1	5.8	5.6
2. Deficit	206	144	94	68	36	-1
3. Gramm-Rudman limit	--	144	108	72	36	0
Recession scenario						
4. Unemployment rate	6.7	7.5	8.8	8.5(?)	?	?
5. Deficit	206	175	174	148	?	?

unemployment and for the budget deficit under the President's five-year plan. Let us, for purposes of illustration, accept these numbers without question. The third line gives the Gramm-Rudman deficit limitations. The president's budget proposals meet these targets, if the rosy growth scenario is fulfilled.

Now let us suppose, instead, that a recession begins in 1987 and continues through 1988 (see lines 4 and 5). If the FY87 unemployment rate is 7.5% instead of 6.5%, the actual deficit for FY87 will be about $30 billion higher -- without any change in the fiscal program. Since this higher deficit comes as a surprise, nothing in Gramm-Rudman prohibits it. Now we come to fiscal 1988. Suppose that a continuing recession is forecast and the Gramm-Rudman targets are suspended while the programs in the president's budget remain intact. If the FY88 unemployment rate is 8.8% rather than 6.3%, the deficit will be about $80 larger than scheduled. But that's perfectly legal under Gramm-Rudman. The hard part comes in fiscal 1989. Now everyone forecasts a recovery, so Gramm-Rudman is not suspended. The deficit limit is $72 billion. But the programs in the president's current budget plan would produce a deficit of $148 billion if the unemployment rate falls only to 8.5% (which is consistent with about 4% real growth) in 1989. Somehow, somewhere an additional $76 in spending cuts above what the president now proposes will have to be found. I don't see how the economy could recover from recession in the face of such massive spending cuts. I fear that it would not.

The problem is that Gramm-Rudman short circuits the automatic stabilizing feature of the federal budget. Doing so was an extremely serious flaw in the legislation, one which Congress, in its wisdom, chose to ignore. But this flaw is quite easy to fix. If we simply defined the targets in terms of the so-called structural deficit instead, the automatic stabilizers would be restored. In my example, a fiscal 1989 structural deficit limit of $72 billion would, if unemployment were 8.5%, allow an actual deficit as large as $154 billion. So no fiscal contraction would be required.

If Gramm-Rudman is declared constitutional by the Supreme Court, or resurrected in some other way, I cannot overestimate the importance of purging it of this reckless feature. While a recession does not appear to be on the horizon, and no one can forecast when one will come, the odds that we will get through 1991 without a recession are slim indeed. Gramm-Rudman runs the real danger of turning a mild recession into a severe one, or of turning a severe recession into a depression. Asking Congress to reject legislation that invites a depression is not, it seems to me, holding it to an unreasonably high standard.

4. HOW SHOULD THE BUDGET BE CUT?

Finally, your letter asked about how the budget deficit should be cut. From a macroeconomic perspective, it matters little. The choice between tax hikes and spending reductions is political, in the best sense of that word: Does the citizenry

want the programs enough to pay taxes to support them? If so, we should raise taxes. If not, we should cut the programs.

However, the administration's insistence that civilian spending cuts shoulder the entire burden has been trumpeted so loudly that it invites comment. The administration is fond of pointing out that federal receipts as a share of GNP are about where they were in the 1970s, while federal expenditures are far higher. That is true. But why start counting there? As Table 1 showed, chronic strutural deficits in the inflation- corrected budget are a recent phenomenon, dating only from the Reagan administration.

If we compare fiscal 1981 with fiscal 1985 (see Table 3), we find that receipts were down from 20.1% of GNP to 18.6%; the difference is 1.5% of GNP. Over that same five-year span, spending was up from 22.7% to 24%, a rise of 1.3% of GNP. That misleadingly suggests two equally-guilty culprits. But most of the increase in the spending share was interest -- interest which was necessitated by the deficits opened up by the tax cuts. Federal spending exclusive of interest was 20.4% of GNP in fiscal 1981 and 20.3% of GNP in 1985. That's an increase, but not much. It suggests to me, speaking now as a citizen rather than as an economist, that taxes should bear a substantial part of the burden of adjusting to smaller deficits.

One last topic seems to bear mentioning. There has been talk of closing part of the deficit by selling federal government assets -- either financial assets like loan portfolios, or real

TABLE 3

OUTLAYS, RECEIPTS, AND THE DEFICIT: 1985 VERSUS 1981

(as percent of GNP)

Item	Fiscal 1981	Fiscal 1985	Change
Outlays	22.7	24.0	+1.3
excluding interest	20.4	20.8	+0.4
Receipts	20.1	18.6	-1.5
Deficit	2.7	5.5	+2.8

assets like the Bonneville Dam and Conrail.

Given the silly way we keep the federal books, such actions do indeed -- in an accounting sense -- reduce the deficit. But they do so only temporarily since you cannot, e.g., sell Conrail every year. However, in an economic sense, such asset sales are utterly meaningless.

Financial assets are the clearest case. What difference can it make if the government reduces its financial assets (as it does when it sells a loan) instead of increasing its financial liabilities (as it does when it floats new federal debt)? We are all worried about budget deficits because they either crowd domestic borrowers out of the credit market or force us to borrow from foreigners. If the federal government sells loans to private individuals or businesses, these individuals or businesses will have less money to lend in the credit markets just as surely as if the federal government had borrowed more itself. The whole thing is a pure bookkeeping fiction.

Selling real, physical assets is not just a bookkeeping fiction. But neither does it reduce the government's claims on the financial markets or reduce the deficit in the long run. Those who buy the Bonneville Dam will either have to borrow the funds themselves or will have that much less money to invest elsewhere, so financial market pressures are not relieved. Furthermore, if federal earning assets are sold at fair market prices, those prices will represent the present discounted value of the expected earnings from the assets. All we will have done is raised present government revenues at the expense of future revenues.

None of this, I hasten to add, implies that "privatization" is necessarily a bad idea. In some cases, it may be a very good idea indeed. My point is that such decisions should be made on the basis of efficiency criteria and on judgments about the appropriate scope of government (what should be nationalized and what should be private), not on the basis of what they do to the measured federal deficit. From a macroeconomic perspective, they are nonevents.

Econ.—f.i.c. & p

Economic Watch

WHO NEEDS GRAMM-RUDMAN TO TAME THE DEFICIT?

BY ALAN S. BLINDER

To balance the budget, President Reagan should appoint a bipartisan commission that doesn't shy away from including tax increases and Social Security on its agenda

ALAN S. BLINDER IS THE GORDON S. REMSCHELER MEMORIAL PROFESSOR OF ECONOMICS AT PRINCETON UNIVERSITY AND A VISITING FELLOW AT THE BROOKINGS INSTITUTION

By passing the Gramm-Rudman balanced-budget bill, Congress has hung the sword of Damocles over the nation's head. Our concern must now be to ensure that the sword never drops. Fortunately, as a strictly economic problem, the deficit is easy to solve.

The reason this simple economic problem led to the political stalemate that spawned the Gramm-Rudman abomination was the President's insistence—in word more than deed—on closing the budget gap without touching taxes, defense spending, or Social Security. These three taboos shrink the eligible base for deficit reduction in fiscal 1986 from about $1.6 trillion (the sum of taxes plus all spending other than interest on the federal debt) to about $350 billion. In this way, an economic molehill was turned into a political mountain.

My belief that curing the deficit problem is easy rests on five premises:

□ The needed deficit reduction is only about half of what Gramm-Rudman seeks to do. Part of the current deficit is an illusion of faulty accounting procedures that wrongly treat the inflation component of interest as an expense. Another part is due to the fact that the economy is still below full employment. These two adjustments come to $90 billion or more. So balancing the budget at full employment with proper inflation accounting would require a deficit reduction of only about $100 billion.

□ While $100 billion may sound like real money, there is no need to achieve balance all at once. By spreading the deficit reduction program over, say, three years, we can avoid the need for severe measures.

□ It is critical to get Social Security and taxes back on the agenda, even though Gramm-Rudman tries to take them off. With them, we can fish for our $100 billion in a large pond of about $1.6 trillion. Without them, we must find our $100 billion in a small pool of less than $600 billion.

□ We can cut $100 billion from the deficit with spending reductions or tax increases that total only $70 billion to $75 billion. No, this is not the new math. It's the old math of interest and debt. Lower deficits mean lower interest rates and a smaller accumulated debt in future years. The government's annual interest bill would shrink by $25 billion to $30 billion under the plan I sketch below.

At this point, any Keynesians who read this magazine will object: Won't budget cuts and tax increases lower aggregate demand, raise unemployment, and enlarge the deficit? That brings me to my fifth premise:

□ The Federal Reserve now appears to be targeting the growth rate of either nominal or real GNP. Under such a policy, the contractionary effects of tighter budgets are automatically canceled by easier money. That is certainly what the Fed should do under current circumstances. And I think it is also what they would do, at least for moderate fiscal changes, though perhaps not for the mammoth budget cuts that Gramm-Rudman might someday trigger.

TWO GIMMICKS. To avoid mechanical budget cuts that no one wants, the President should appoint a bipartisan commission on reducing the deficit, as some people have proposed. Its purpose would be to depoliticize the issue, just as the commissions on Social Security and the MX missile depoliticized two far more difficult issues. Yes, I know a Presidential commission is only a gimmick. But it may take one gimmick (the commission) to beat another gimmick (Gramm-Rudman). And President Reagan has used bipartisan commissions to help him out of tight spots before.

Here is a concrete example of what such a commission might propose: The deficit should be cut in three annual installments of $24 billion each vs. Gramm-Rudman's five installments of $36 billion each, with half the programmatic changes coming on the tax side and half on the spending side. In the interest of fairness, spending cuts should be apportioned equally among defense, Social Security (including medicare), and everything else—since these three portions of the budget are almost exactly equal in size. Then the Gramm-Rudman bill should be repealed.

Agreement on spending cuts should come easily since they are so small. Defense spending might rise only 4.5% per year rather than 6%. Who but Caspar W. Weinberger would deem that a hardship on the Pentagon? The annual cost-of-living increment for a typical Social Security beneficiary receiving a monthly check of $500 would fall by 25¢ per day. Is that being cruel to the elderly?

On the tax side, $12 billion per year in new revenues for three years should not be hard to find. I'd like to get it by closing a few of the more glaring income-tax loopholes and by raising taxes on gasoline, tobacco, and liquor. But there are many other ways.

There is nothing sacrosanct about this particular plan. My point is that a dispassionate look at the numbers shows that the deficit problem does not merit the hysterical reaction embodied in Gramm-Rudman. It is only politics, the art of making the possible impossible, that has tied the nation in a Gordian knot. A Presidential commission just might be the way to cut that knot.

The CHAIRMAN. Thank you very much, Dr. Blinder.

At this time, Dr. Bosworth, we welcome your testimony and, of course, it will be submitted in its entirety for the record.

STATEMENT OF BARRY P. BOSWORTH, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. BOSWORTH. Thank you, sir.

I also have written testimony, so I will try to summarize a couple of points that I think go to the questions that you asked on the invitation.

I think the central question that we are faced with today is whether or not the United States can make a transition to a more prudent pay-as-you-go budget policy without precipitating a recession or resurgence of inflation. I believe that the answer to that question should be yes and that the economic situation in 1986–87 provides something close to the ideal environment in which to begin that adjustment.

That conclusion, however, is highly dependent upon the clear recognition that what is envisioned is a shift in the policy mix, a tighter fiscal policy offset by an easing of monetary policy and not just a reduction in the budget deficit. Actions of the type proposed by the Gramm-Rudman-Hollings Act place a heavy burden on the Federal Reserve to sustain the economic expansion.

The Federal Reserve has also waffled on its commitment to maintaining real growth in the 3 to 4 percent range. I would agree with everything I think that Alan Blinder earlier had to say with respect to the concerns that we have about the dedication of the Federal Reserve to maintaining a strong economic expansion in the face of these budget actions.

I think the Gramm-Rudman-Hollings Act is a risky approach, but is superior to the current stalemate between the President and the Congress in which nothing is done. I would really like to focus, I think, on three issues. One, what is the outlook for the economy in the absence of fiscal policy changes.

Second, what is the longrun target for reductions in the budget deficit, and third, what are the major adjustment problems that we will face if those reductions actually occur.

I think economic conditions in 1986–87 for the United States and the rest of the world would provide an unusually good opportunity to begin to move back to a pay-as-you-go budget policy. The economy in 1986 appears to be surprisingly strong.

Inflation will be climbing and should not inhibit efforts of the Federal Reserve to offset the deflationary effects of the fiscal policy actions. Declines in oil prices will offset almost all the inflationary effect of a lower exchange rate and provide a strong stimulus to the private sector in consumer spending as they get to keep a lot more of their real income.

In addition, Europe faces a much improved economic situation. Declining value of the American dollar will sharply reduce inflationary pressures in Europe. They have completed most of their adjustments on the fiscal side to eliminating the large budget deficits that they had in the past and, third, they will be impacted even more than the United States by lower oil prices.

Therefore, I think we can look to the other industrial countries to pick up a lot of the burden that has previously fallen on the United States to sustain world economic growth. Except for Mexico, the less developed countries will benefit from the changed economic environment of lower oil prices and lower interest rates. One question, though, that I would like to discuss in some detail is what should be, so to speak, the longrun goals of fiscal policy. The Gramm-Rudman-Hollings Act specifies a path for gradually reducing the budget deficit to zero by the year 1991.

The idea of gradual adjustment makes sense because after both 4 years the United States and the rest of the world economy have adjusted to a large U.S. budget deficit. The move back toward balance will be as wrenching in its impact on the economic structure as the original creation of the imbalance. A reduction in the budget deficit will have a deflationary effect on the demand in the domestic economy and because it lags, it will take time for monetary policy to provide the needed offsets.

Other countries have become highly dependent upon an excessive level of exports to the United States as a source of stimulus to their own economies. They, too, will need time to adjust.

The inflationary impact of the decline in the exchange rate, higher import prices, may be easier to absorb if spread over several years. Still, it is important to distinguish between the shortrun adjustment problems, the need for a flexible fiscal policy to absorb unanticipated changes in private demand and the longrun target for fiscal policy.

The issue of longrun targets is most easily addressed within the context of the Nation's balanced savings in investment. To try to highlight some of those issues, I provided a table for the committee behind page 7 of the testimony that shows recent trends in national savings investment. What is most striking about that table is the precipitous decline in the national rate of savings and investment in the United States from an average of about 8 percent of national income to less than 4 percent.

In effect, the United States has been in the midst of an enormous self-indulgent national consumption boom spending over 96 percent of all the income it earns every year. That decline is almost entirely due to an increased rate of dissaving by the Government.

The impact on domestic investment—the collapse of national saving has been buffered to a surprising degree by an inflow of borrowed resources from abroad. What that means is that in just a few years the United States has liquidated a stock of foreign assets built up over the prior half century and is now a net debtor nation.

That is not a sustainable economic situation and a day of reckoning even though we may not know the date is bound to come. Over the last decade the Department of Agriculture has bickered endlessly over the structure of the tax system and its implications for domestic capital formation.

What we must realize is it does no good to seek means of promoting domestic investment if this Nation is unwilling to supply the savings to finance it. Without an increase in national saving, every dollar in increased domestic investment will simply be financed by an equal increase in the current account deficit with other countries.

In other words, it is foreigners not Americans who are today providing the funds to finance our national investment. That foreign borrowing is already equivalent to over half of net investment in the United States. That also means that all the benefits of that investment are largely going to accrue to foreigners in the future in the form of higher interest and dividend payments.

The domestic financing of capital formation must come either from an increase in private saving, households, and business firms or from a reduction in Government dissaving, the budget deficit. In recent years we have given away billions in tax incentives to promote private saving. I think it is now about time to conclude that those policies have failed.

There has been no rise in private savings rate despite tremendous increases in the aftertax return to holders of capital assets. If the United States is serious about increasing the national rate of savings and investment, it must do so by reducing the budget deficit.

In table 1, I outlined various rates of net capital formation that could be expected under alternative budget policies. Throughout I assume that the monetary policy will be conducted so as to maintain the economy along the high employment path.

I also assume that the private sector savings rate would recover slightly to its postwar average of 9 percent and that the United States returns to a balance in its current account with other countries.

I do not go so far as to assume that the foreign debt run up during the 1980's will be repaid. Given these assumptions, it is possible to estimate the resources available to finance domestic investment for several alternative budget deficit targets.

As a point of departure, the CBO projects a steady decline in the deficit under current policies to 1.7 percent of GNP in 1991. A national income accounts basis that would translate into about 2 percent of national income and with national savings rate of about 7 percent. Assuming that we do not continue to borrow abroad, that budget strategy would allow for a slight rise in the net rate of capital accumulation from 6.5 percent in 1985 to 7 percent by the early 1990's.

That would, however, be substantially below the rate achieved as recently as the 1970's. A budget deficit of zero in 1991, the Gramm-Rudman targets, would allow the investment share to rise at the historical average of about 9 percent of national income.

Such an investment rate would be close to that achieved during past periods of strong economic activity such as the mid-1960's, 1972–73 and 1977, 1978. An alternative often discussed by economists and in particular, Alan Blinder, would be to have a balanced inflation adjusted budget.

Account would be taken of the decline in the real value of the public debt due to inflation. Such a target would imply a budget deficit of 1.4 percent of NNP at a 4 percent inflation rate in 1991. It is, coincidentally, equivalent to the average historical experience.

However, I fail to see why we should aim for nothing better than the average of the past. An increased rate of capital formation would yield substantial social benefits to the United States, and the historical average to which we might aspire has been frequently

held down by recession. Furthermore, in one important respect, the projections of the budget understate the magnitude of the deficit problem.

In its retirement programs, the United States does not fully fund the future liability—retirement costs—of each generation, preferring instead a partial pay-as-you-go system by which current workers devote a share of their income to help finance the currently retired in return for an equal treatment when they retire. These two systems are roughly equivalent when the retired are a constant share of the population. But when the retired rise as a proportion of the total population, as is expected to happen after the year 2020, there is an extra burden placed on future workers who must devote a larger share of their incomes to support the elderly.

In recognition of this problem, the Congress acted in 1983 to reduce future benefits of Social Security and to increase taxes on current workers. The objective was to reduce the extra burden on future generations by increasing saving of the current generation, investing in a larger stock of capital, and raising national income in future years.

In effect, the current generation would pay a portion of its own retirement costs, equivalent to the rise in the proportion of the population that will be retired, avoiding the extra cost to future workers. As a result, the Social Security system will run a substantial surplus for the next three decades, accumulating to about $12 trillion in the year 2030, declining rapidly thereafter.

If, however, the surplus in the trust fund is used to finance the deficit in the rest of the budget, and thus consumption of the current generation, no future benefit is obtained. In effect, the United States would be simply using a regressive wage tax to finance programs, such as defense, of benefit to the general population.

By the 1990's, this extra saving in the trust fund will average about 1 percent of GNP. Thus, validation of the 1983 Social Security amendments requires that the United States aim for a total budget deficit that is smaller by about 1 percent of GNP than it would otherwise be. This is a more ambitious target for the budget than the historical record or that proposed by Gramm-Rudman-Hollings.

As shown at the bottom of table 2, if the Social Security fund is not used to support the consumption of the current generation, the total budget would show a surplus equal to 1 percent of NNP. As a result, national saving would be sufficient to support a potential net investment share equal to 10 percent of NNP.

Which such an investment rate has been achieved only rarely and then only at the peak of historical business cycles in the United States, it would largely eliminate the extra burden imposed by the growth of the retired population in future decades.

This is a highly simplified exercise for projecting trends in the national saving-investment balance, but I do believe that it illustrates the substantial capacity for the United States to adjust successfully to a wide range of alternative budget strategies. I also believe there are strong arguments in favor of a higher rate of national saving and investment than the United States has had in the past. If we do not intend to finance a higher rate of capital for-

mation, why do we waste so much time arguing over tax incentives for investment?

Finally, the Congress should not be mislead by the declining deficits embedded in the current service projections of OMB and CBO into believing that the targets of GRH will be easy to achieve. Budget projections require assumptions, and, if you make enough of them, you can get any deficit you want.

CBO, for example, decided this year to change from a previous assumed growth of defense spending of 5.5 percent annually, after adjusting for inflation, to zero. While the assumed 5.5 percent was absurdly high, I know of nc actions or plans by the Congress or the administration that would make the zero real growth consistent with current defense policy.

Similarly, both CBO and OMB embedded the first stage cuts of Gramm-Rudman-Hollings into the baseline projections for nondefense spending, while only CBO produced a meaningful baseline for defense. Both also assume a path of continued decline in interest rates, and thus debt service costs, that is likely to result only if the Gramm-Rudman-Hollings reductions actually occur.

We should not forget that the current deficit is in excess of $200 billion annually, and it will stay in that range unless the Congress and the President enact wrenching changes in the present path of spending and taxation. We are seeking to reduce the deficit by a full 5 percentage points of GNP over a 5-year period—doubling our national saving rate. That will be very difficult to achieve.

Let me just try to say a few words then in the short turn about the adjustment problems that the United States will face to do that. I think cuts in budget outlays or tax increases will have an unambiguously depressive effect on the domestic economy in the short run. The key to avoiding this tendency toward slower economic growth is prompt and strong action by the monetary authorities to promote an offsetting rise in private spending.

An easing of monetary policy would have positive effects on homebuilding, business investment, and consumer durables. But stronger domestic demand alone will not be enough. They key adjustment lies with the decline in the exchange rate and a smaller foreign trade deficit—larger exports and fewer imports.

The Gramm-Rudman-Hollings Act calls for a reduction in the budget deficit that totals 5.5 percent of NNP between 1985 and 1991. In order to sustain the expansion, private demand must rise by an equal offsetting amount. Elimination of the current account deficit with other countries would provide 3 percentage points, leaving 2.5 percent of output to be absorbed by a higher level of domestic investment.

The improvement of the current account will require a fall of the exchange rate at least back to the levels of 1980 and perhaps below, the rise in investment will require a major decline in interest rates beyond what has already been achieved.

Calendar years 1986 and 1987 are an ideal time to begin this process because: One, lower interest rates would improve the health of the financial system, benefiting financial intermediaries, agriculture, and the debtor nations, and two, falling oil prices will provide some offset to the inflationary pressures that can be expected to follow a decline in the exchange rate. It is much better to

begin the process of adjusting the budget in a strong economy rather than waiting for the problems to become more manifest.

The major problem arises from uncertainties as to whether anything will actually happen until the last minute. An offsetting adjustment in monetary policy plays a key role and that policy can be expected to operate with a considerable lag. Yet, the Federal Reserve will be uncertain until October 1986, and perhaps later, as to precisely what fiscal actions will be taken. In other words, a coordinated shift in the policy mix might be difficult to arrange.

A second concern lies with the anticipated decline in the exchange rate. In past years a growing trade deficit provided the major response to the growing budget deficit. So, too, as the process reverses, the trade deficit must decline. An improved trade deficit is expected to provide over half of the offset to reduced fiscal stimulus.

If, however, other countries resist the decline in the dollar, the expected improvement in the trade deficit may not materialize. The decline in U.S. interest rates, which is expected to follow a shift in the fiscal-monetary policy mix, will result in lower rates in other countries, and that alone should benefit their economies. Higher growth abroad would, through an income effect, improve U.S. export performance.

But, the United States also needs the improvement in competitiveness that would accompany a return of the exchange rate to more normal levels. Thus, other countries must be willing to allow the dollar to decline, and they must be willing to replace the stimulus that they now receive from exports to the United States with domestic measures. A lower level of interest rates alone may not be enough.

I am cautiously optimistic that this will occur. Lower oil prices and a lower value of the dollar provide Europe in particular with an excellent opportunity to aim for higher growth—inflation will be much less of a constraining influence. In the first half of the 1980's, many European countries focused on reducing their own budget deficits which had grown enormously during the late 1970's. For many of these countries, that goal has now been achieved. Simply the return of fiscal policy to a more neutral stance should provide an opportunity for faster growth within Europe as a whole.

[Testimony resumes on p. 505.]

[The prepared statement of Mr. Bosworth follows:]

Prepared Statement of Barry P. Bosworth*

The Gramm-Rudman-Hollings (GRH) bill has initiated a major new round of debate in Washington over budget policy. Thus far, however, the focus of attention has fallen on the implications of expenditures reductions in individual programs and the possibility of a tax increase. Less attention has been paid to the challenges that the program raises for the monetary authorites as they attempt to maintain a non-inflationary expansion of the domestic economy. This is also the first time in over four years in which the United States is seriously contemplating a reversal of a fiscal policy that has been consistently stimulative on the demand side of the economy.

Can the United States make the transition to a more prudent pay-as-you-go budget policy without precipitating a recession or a resurgence of inflation? I believe that the answer to that question

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* Mr. Bosworth is a Senior Fellow in Economics at the Brookings Institution. The views expressed in this statement do not reflect those of other Brookings staff members or the officers and trustees of the Brookings Institution.

should be yes and that the economic situation in 1986-87 provides close to the ideal environment in which to begin that adjustment. That conclusion, however, is highly dependent upon the clear recognition that what is envisioned is a shift in the policy mix -- a tighter fiscal policy offset by an easing of monetary policy -- and not just a reduction in the budget deficit. Actions of the type proposed by the G-R-H act place a heavy burden on the Federal Reserve to sustain the economic expansion. he GRH act is a risky approach, but it is superior to the current stalemate between the President and the Congress in which nothing is done.

I propose to address the consequences of a reduction in the budget deficit along the lines envisioned in GRH through an examination of a series of subsidiary questions.

- What is the outlook for the economy in the absence of fiscal policy changes?
- What should be the long-run target for reductions in the budget deficits? and
- What are the major adjustment problems that we face if the deficit reductions actually occur.

Current Outlook

For over four years, the United States has been in the midst of a self-indulgent national consumption boom, financed by net borrowing abroad. Today the United States consumes 96.6 percent of its annual

income, leaving it with the lowest rate of national saving and investment since World War II. In 1984 and 1985, the federal budget deficit absorbed over 60 percent of net private saving. It has proved possible to finance this situation only by borrowing an incredible 3 to 4 percent of the annual national income overseas. Thus, for example, the United States is experiencing a quite normal rate of domestic investment--the only change is that it is investment by foreigners, not Americans, and they will receive most of the future benefits in interest and dividend payments.

When the less-developed countries encountered debt-repayment problems in the early 1980s, our government counseled them to tighten an already short belt and live within their means. We could now use a little of our own advice.

It has proved almost impossible, however, to convince the average American that this constitutes a serious problem. They get to keep their favorite expenditure programs, while taxes stay low. The cost of the foreign borrowing lies many years in the future and the need to repay the debt is simply not an issue of public concern. Still, it is worth recalling the major long-term costs of the current policies.

- A foreign debt that is growing at about $125 billion annually and that obligates future generations to interest and principal repayments that will mount steadily in future years.
- An overvalued dollar, created by the need to borrow overseas, has drastically reduced the competitiveness of American industry in

world markets.

-- The United States now has a trade deficit in every major industrial product line, including even such high tech industries as computers.

-- The exchange rate is a major factor behind the collapse of agriculture as the United States has become a high-cost producer in world markets.

-- There is an increasing shortfall of domestic production in the export- and import-competing industries as facilities are being moved overseas.

- Both the accumulation of debt and the loss of the industrial base imply that the longer we wait, the larger will be the fall in the value of the dollar.

  -- A lower exchange rate will be required to earn the foreign exchange needed to pay interest on the debt

  -- A larger decline will be required to rejuvenate domestic capacity in the tradeable goods industries.

- The decline in the exchange rate, when it occurs, will add to domestic inflation pressures.

- There is a risk (presently small) of a sudden and major collapse in the exchange rate if foreigners come to question the future viability of the U. S. economy.

These problems, however, imply that the cost of the current consumption binge lies largely in the future. The near-term outlook, as reflected in the CBO forecast, is for a continued modest growth of the U.S. economy of about 3-4 percent annually.

- The budget deficit provides a sustained, high level of stimulus to the domestic economy.
- While monetary policy is the only available tool for controlling overall economic performance, it is in an unusually strong position.
  - -- The high level of interest rates has lead to a substantial backlog of pentup demand, and
  - -- monetary policy can operate essentialy as a breke on a buoyant domestic economy, clamping down when demand growth threatens to accelerate, and letting up when growth begins to slow.
  - -- The trade balance has emerged as a major new channel through which monetary policy, in its effect on the exchange rate, can influence overall economic activity.
- Inflation should continue to remain low, as the Federal Reserve Board seems intent on maintaining domestic unemployment well above 6 percent (no significant domestic demand pressures) and falling commodity prices provide a negative impact on the price level.
- Monetary policy seems to be aiming for a growth rate target of GNP consistent with nonacceleration of inflation--approximately 3

to 4 percent annually.

-- When growth threatens to slow, policy eases and interest rates decline.

-- When growth accelerates, policy tightens and interest rates tend to rise.

- This policy has worked well because the Fed has not been faced with a crisis, such as a collapse of the exchange rate, that would force it to choose between competing economic goals, and the public has been willing to support a continued high level of unemployment to hold down inflation.
- The Federal Reserve still has room to maintain the expansion by allowing interest rates to drift down to more normal levels.

In summary, the debt-generating policies of the United States are bound to lead to a day of reckoning, but noone has the basis to predict precisely when it will actually occur. In the meantime, a policy that promotes domestic consumption, while leaving the financing of investment to foreigners, has proved to be highly polular.

What Should be the Goal of Fiscal Policy?

The Gramm-Rudman-Hollings bill specifies a path for gradually reducing the budget deficit to zero by the year 1991. The idea of gradual adjustment makes sense because after four years both the United States and the world economy have adjusted to a large U.S. budget deficit. The move back towards balance will be as wrenching in its impact on the economic structure as the original creation of the

imbalance. A reduction in the budget deficit will have a deflationary effect on demand in domestic economy, and because of lags, it will take time for monetary policy to provide the needed offsets.

-- Other countries have become highly dependent upon an excessive of exports to the United States as a source of stimulus to their own economies. They will need time to adjust.

-- The inflationary impact of a decline in the exchange rate, higher import prices, may be easier to absorb if it is spread over several years.

Still it is important to distinguish between the short-run adjustment problems -- the need for a flexible fiscal policy to absorb unanticipated changes in private demand -- and the longrun target for fiscal policy. The issue of longterm targets is most easily addressed within the context of the balunce of the nation's saving and investment.

A summary of recent trends in national saving and investment is shown at the tcp of table 1. There has been in the 1980s a precipitous decline in the national rate of saving and investment from a historical average of about 8 percent of national income to less than 4 percent.[1] That decline is almost entirely due to an increased rate of dissaving

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1. That decline seems particularly incongruous given the supply side rhetoric of the early 1980s when the Administration condemned the supposedly consumption-promoting policies of the past and promised large gains in the national rate of capital formation.

Table 1. Saving and Investment as Shares of National Product, 1951-85

Percent of Net National Product

Period	National Saving			Investment	
	Private	Government	Total	Net Foreign	Domestic
1951-60	8.4	-0.7	7.7	0.3	7.4
1961-70	9.2	-1.0	8.1	0.6	7.6
1971-80	9.7	-2.0	7.7	0.3	7.4
1981-85	8.6	-4.7	3.9	-1.3	5.2
1985	8.8	-5.4	3.4	-3.1	6.5
Budget Options for 1991					
CBO Baseline	9.0	-2.0	7.0	0.0	7.0
Gramm-Rudman-Hollings	9.0	0.0	9.0	0.0	9.0
Inflation-Adjusted Balance	9.0	-1.3	7.7	0.0	7.7
Unified Budget Balance	9.0	1.0	10.0	0.0	10.0

Source: U.S. Department of Commerce and author's estimates.

a. Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals GNP minus capital consumption allowances.

b. Business and household saving. Pension funds of state and local government employees are allocated to private saving.

by government -- private saving continues to represent a share of national income that is close to the postwar average. The impact on domestic investment of the collapse of national saving has been buffered to a surprising degree by an inflow of borrowed resources from abroad. In just a few brief years the United States has liquidated a stock of foreign assets built up over the prior half century and is now a net debtor nation.

Over the last decade the U.S. has bickered endlessly over the structure of the tax system and its implications for domestic capital formation. Today the Congress is engaged in another round of debate over tax policy, a debate in which the impact of taxes on investment demand again plays a prominent role. Yet, it does no good to seek means of promoting domestic investment if the nation is unwilling to supply the saving to finance it. Without an increase in the national saving, every dollar in increased domestic investment will be financed by an equal increase in the current account deficit with other countries. That foreign borrowing is already equivalent to about half of net domestic investment (3.1 versus 6.5 percent of national ouput in 1985). Today, investment is limited by the shortage of domestic saving and the high exchange rate that goes with it, not taxes.

The domestic financing of capital formation must come either from increases in private saving (households and business firms) or from a reduction in government dissaving (the budget deficit). In recent years we have given away billions in tax incentives to promote private

saving. I think it is now about time to conclude that those policies have failed: there has been no rise in the private saving rate despite tremendous increases in the after-tax return to holders of capital assets (see table 1).[2] If the United States is serious about increasing the national rate of saving and investment, it must do so by reducing the budget deficit.

In table 1 I have outlined various rates of net capital formation that could be expected under alternative budget policies. Throughout I assume that monetary policy will be conducted so as to maintain the economy along a high employment path. I also assume that the private sector saving rate recovers to its postwar average of 9 percent of net national product (NNP), and that the United States returns to a balance in its current account.[3] I do not go so far as to assume that the foreign debt, run up during the 1980s, is repaid.

Given these assumptions, it is possible to estimate the resources avaliable to finance domestic investment for several alternative budget deficit targets. As a point of departure, the CBO projects a steady decline in the deficit, under current policies, to 1.7 percnt of GNP in

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2. It is sometimes argued that the budget deficit is of no real concern because private saving will adjust automatically so as to leave the national saving rate unchanged. Clearly, that has not happened in the 1980s.

3. I have allocated the employee pension payments of state and local governments to the income and thus the saving of their employees, the same treatment as is used for private firm pensions. As a result the budget of state -local governments is essentially balanced.

1991. On a national accounts basis that would translate into about 2 percent of NNP, and a national saving rate of 7 percent. Assuming that the U.S. does not continue to borrow abroad, that budget strategy would allow for a slight rise in the net rate of capital accumlation from 6.5 percent of NNP in 1985 to 7 percent in the early 1990s. That would, however, be below the rate achieved during the 1970s.

A budget deficit of zero in 1991 -- the Gramm-Rudman-Hollings objective -- would allow the investment share to rise above the historical average to about 9 percent of NNP. Such an investment rate would be close to that achieved during past periods of strong economic activity, such as the mid-1960s, 1972-73, and 1977-78.

An alternative, often discussed by economists, would be to have a balanced inflation-adjusted budget. That is, account would be taken of the decline in the real value of the public debt due to inflation. Such a target would imply a budget deficit of 1.4 percent of NNP at a 4 percent inflation rate in 1991. It is, coincidentally, equivalent to the average historical experience.

However, I fail to see why we should aim for nothing better than the average of the the past. An increased rate of capital formation would yield substantial social benefits to the U.S., and the historical average to which we might aspire has been frequently held down by recession. Furthermore, in one important respect the projections of the budget understate the magnitude of the deficit problem.

In its retirement programs the United States does not fully fund the future liability (retirement costs) of each generation, preferring instead a partial pay-as-you-go system by which current workers devote a share of their income to help finance the currently retired in return for an equal treatment when they retire. These two systems are roughly equivalent when the retired are a constant share of the population. But, when the retired rise as a proportion of the total population, as is expected to happen after the year 2020, there is an extra burden placed on future workers who must devote a larger share of their incomes to support the elderly.

In recognition of this problem, the Congress acted in 1983 to reduce future benefits of social security and to increase taxes on current workers. The objective was to reduce the extra burden on future generations by increasing saving of the current generation, investing in a larger stock of capital, and raising national income in future years. In effect, the current generation would pay a portion of its own retirement costs, equivalent to the rise in the proportion of the population that will be retired, avoiding the extra cost to future workers. As a result, the social security system will run a substantial surplus for the next three decades, accumulating to about $12 trillion in the year 2030, declining rapidly thereafter. If, however, the surplus in the trust fund is used to finance the deficit in the rest of the budget, and thus consumption of the current generation, no future benefit is obtained. In effect, the United

States would be simply using a regressive wage tax to finance programs, such as defense, of benefit to the general poulation.

By the 1990s this extra saving in the trust fund will average about 1 percent of GNP. Thus, validation of the 1983 social security amendments requires that the United States aim for a total budget deficit that is smaller by about 1 percent of GNP than it would otherwise be. This is a more ambitious target for the budget than the historical record or that proposed by Gramm-Rudman-Hollings.

As shown at the bottom of table 2, if the social security fund is not used to support the consumption of the current generation, the total budget would show a surplus equal to one percent of NNP. As a result, national saving would be sufficient to support a potential net investment share equal to 10 percent of NNP. While such an investment rate has been achieved only rarely and then only at the peak of historical business cycles in the United States, it would largely eliminate the extra burden imposed by the growth of the retired poulation in future decades.

This is a highly simplified exercise for projecting trends in the national saving-investment balance, but I do believe that it illustrates the substantial capacity for the United States to adjust successfully to a wide range of alternative budget strategies.[4] I also believe there are strong arguments in favor of a higher rate of national saving and investment than the United States has had in the past. If we do not intend to finance a higher rate of capital

formation, why do we waste so much time arguing over tax incentives for investment?

Finally, the Congress should not be mislead by the declining deficits embedded in the current service projections of OMB and CBO into believing that the targets of GRH will be easy to achieve. Budget projections require assumptions, and, if you make enough of them, you can get any deficit you want. CBO, for example, decided this year to change from a previous assumed growth of defense spending of 5.5 percent annually, after adjusting for inflation, to zero. While the assumed 5.5 percent was absurdly high, I know of no actions or plans by the Congress or the Administration that would make the zero real growth consistent with current defense policy. Similarly, both CBO and OMB embedded the first stage cuts of GRH into the baseline projections for nondefense spending, while only CBO produced a meaningful baseline for defense.. Both also assume a path of continued decline in interest rates, and thus debt service costs, that is likely to result only if the GRH reductions actually occur.

We should not forget that the current deficit is in excess of $200 billion annually, and it will stay in that range unless the Congress and the President enact wrenching changes in the present path of

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4. the calculation probably overstates the change in domestic investment by excluding adjustments in other components. A 10 percent national saving rate, for example, would probably produce a current account surplus -- overseas investment.

spending and taxation. We are seeking to reduce the deficit by a full 5 percentage points of GNP over a 5 year period -- doubling our national saving rate. That will be very difficult to achieve.

Adjusting to a Smaller Budget Deficit

Cuts in budget outlays or tax increases will have an unambiguously depressive effect on the domestic economy in the shortrun. The key to avoiding this tendency toward slower economic growth is prompt and strong action by the monetary authorities to promote an offsetting rise in private spending. An easing of monetary policy would have positive effects on home-building, business investment, and consumer durables. But stronger domestic demand alone will not be enough. The key adjustment lies with the decline in the exchange rate and a smaller foreign trade deficit -- larger exports and fewer imports.

The GRH act calls for a reduction in the budget deficit that totals 5.5 percent of NNP between 1985 and 1981. In order to sustain the expansion, private demand must rise by an equal offsetting amount. Elimination of the current account deficit with other countries would provide 3 percentage points, leaving 2.5 percent of output to be absorbed by a higher level of domestic investment. The improvement of the current account will require a fall of the exchange rate at least back to the levels of 1980 and perhaps below, the rise in investment will require a major decline in interest rates beyond what has already been achieved.

Calendar years 1986 and 1987 are an ideal time to begin this process because: (1) lower interest rates would improve the health of the financial system, benefiting financial intermediaries, agriculture and the debtor nations, and (2) falling oil prices will provide some offset to the inflationary pressures that can be expected to follow a decline in the exchange rate. It is much better to begin the process of adjusting the budget in a strong economy rather than waiting for the problems to become more manifest.

The major problem arises from uncertainties as to whether anything will actually happen until the last minute. An offsetting adjustment in monetary policy plays a key role and that policy can be expected to operate with a considerable lag. Yet, the Federal Reserve will be uncertain until October 1986 and perhaps later as to precisely what fiscal actions will be taken. In other words, a coordinated shift in the policy mix might be difficult to arrange.

A second concern lies with the anticipated decline in the exchange rate. In past years a growing trade deficit provided the major response to the growing budget deficit. So too, as the process reverses, the trade deficit must decline. An improved trade deficit is expected to provide over half of the offset to reduced fiscal stimulus. If, however, other countries resist the decline in the dollar, the expected improvement in the trade deficit may not materialize. The decline in U.S. interest rates, which is expected to follow a shift in the fiscal-monetary policy mix, will result in lower rates in other

countries, and that alone should benefit their economies. Higher growth abroad would, through an income effect, improve U.S. export performance. But, the United States also needs the improvement in competitiveness that would accompany a return of the exchange rate to more normal levels. Thus, other countries must be willing to allow the dollar to decline, and they must be willing to replace the stimulus that they now receive from exports to the United States with domestic measures. A lower level of interest rates alone may not be enough.

I am cautiously optimistic that this will occur. Lower oil prices and a lower value of the dollar provide Europe in particular with an excellent opportunity to aim for higher growth--inflation will be much less of a constraining influence. In the first half of the 1980s many European countries focused on reducing their own budget deficits which had grown enormously during the late-1970s. For many of these countries, that goal has now been achieved. Simply the return of fiscal policy to a more neutral stance should provide an opportunity for faster growth within Europe as a whole.

The rigidity imposed on fiscal policy by the fixed targets of the GRH act is a serious problem. It puts a major reponsibility on the monetary authorities who are being asked to undertake an active policy of offset to the fiscal restraint rather than reacting passively to developements. If the United States should encounter a major exchange rate crisis, the Federal Reserve may be tempted to abandon the goal of domestic balance in favor of an emphasis on external balance. The

United States could be caught attempting to achieve two contradictory goals with a single policy tool. There is only a limited ability to adjust the fiscal targets to unforeseen economic circumstances. Apparently that risk is necessary to force action by the President and Congress. The current situation also has high risks.

Alternative Budget Reduction Strategies

I have little to contribute on the specifics of the budget measures taken to reduce the deficit. That choice is primarily political, not economic. Let me voice just a few concerns.

First, there is discussion about the implications for investment of any increased taxation of capital income. I agree that taxes do affect investment decisions, but often too much attention is devoted to that issue alone, while other, equally important factors are ignored. Today, investment is being driven offshore by high financing costs and an exchange rate that makes it impossible for many domestic industries to compete in world markets. Much more can be done to provide for more capital formation through efforts to reduce the federal deficit, interest rates, and the exchange rate. That benefits of that policy will accrue to a much wider group than those who might benefit from a few more special provisions for the taxation of capital income.

While the Congress is bombarded with further requests to exempt certain types of capital income from taxation, it should remember that it is the tax on labor income, not capital, that has risen in recent decades. Tax relief for one group must be paid for by others; and,

while taxes distort saving and investment decisions, they also distort work effort. The issue of whether economic growth would be increased by a shift of taxes from capital to labor is very complex -- particularly in an open economy with international capital markets -- and I don't believe that any economist knows the answer. Basically, the choice between tax increases and expenditure reductions is a vital political issue; but, within the range of change being discussed, the economic effects are secondary to the effects of reducing the deficit itself.

Second, I am quite concerned that the budget targets may be met by a series of financial gimmicks that simply manipulate the totals of the budget without altering its economic effects. For example, it has been proposed that the deficit targets could be met by selling financial assets presently held by the government. As each of us is aware in managing our own budgets, the sale of a financial asset is simply a substitute for issuing more debt. Such a transaction would have no effect on the national balance of saving and investment outlined earlier.

Third, I am less concerned than previously about simply allowing the mandatory cuts imposed by the GRH act to occur. If taxes are to be ruled out by Presidential veto, allocating the cuts across the board may be a reasonable starting point. Some of the cuts will seem unreasonable, but there is nothing in the act that prevents the President and the Congress from later restoring some of those cuts as

long as they provide the revenue to pay for them. The budget that emerges from the mandatory cuts is not final, and it seems to me as good a basis for consideration of alternatives as any other. I see no particular merit to the alternative budget proposed by the President. I have no basis for judging the appropriate level of defense spending, but, if we need it, we should be willing to pay for it.

Finally, I believe that the 1983 agreement on social security does serve as a model for the process by which the Congress might proceed to restore balance between outlays and taxes. Given a financing crisis, the Congress cut benefits to future retirees and raised taxes. The benefit of a trust fund arrangement is that it forces a simultaneous decision on both providing benefits and paying for them. The Social Security trust fund is now in a substantial surplus position and is not a cause of the budget deficit. In fact, as mentioned earlier, it is being used to finance consuption in other areas.

A similar approach might be applied to other areas of the budget, such as defense and medical care. The suggestion, following that of the GRH act, is that each program be allocated a portion of the deficit in proportion to is share in total outlays -- a reasonable, although arbitrary, point of departure. For each program the Congress would then be forced to vote a combination of outlay reductions or tax increases equal to its share of the budget deficit. The basic principle is simple: if you want it you must pay for it.

The CHAIRMAN. Thank you very much, Mr. Bosworth.

Let me begin the questioning by asking first Dr. Bosworth, the other day we had Secretary of the Treasury James Baker here. The question was raised about the impact of being a net debtor nation and its impact on productive investment. Secretary Baker, I think I am quoting him correctly, said, "Well, so what? We were a net debtor nation in the 19th century and even though we are a net debtor nation now we are making productive investments."

Would you agree with that statement by Secretary of the Treasury Baker?

Mr. BOSWORTH. No, I would not. I would not because, in fact, we are not financing a higher level of investment in the United States. As I showed you in the table in my testimony, the investment in 1985 is, in fact, lower in the United States than it was in prior decades.

Instead, the big difference between now and the 1800's, is in the 1800's we borrowed money overseas to invest in productive investments, namely, our railroad system. We paid off those debts. Today we are borrowing overseas to finance consumption, particularly public consumption. The current account deficit is largely just an offset to our current deficit so we are not investing in rates of higher capital formation and that is not what that foreign borrowing is going for.

The CHAIRMAN. Let me ask a question of Dr. Greenspan. Dr. Greenspan, Chairman Volcker told the Senate Banking Committee yesterday that CBO and OMB budget projections on falling deficits under current policies may be optimistic. He said, "There is a difference between assuming that and seeing it develop."

Dr. Greenspan, I have two questions for you. One, do you agree that CBO baseline projections are too optimistic; and two, if so, what would you recommend that Congress use for the budget resolution?

Mr. GREENSPAN. I think they are optimistic and I think CBO recognizes that. In fact, I suspect that as they testify on these issues and as the issues continue to develop, you are going to find a goodly part of the reduction in the deficit occurs as a consequence of the presumption that, in fact, the budget deficit will, in fact, be brought down and in tandem interest rates will come down and interest costs will come down.

Economic growth will go up, revenues will go up, especially corporate profit taxes, which tend to be excessively estimated in these times of exercises, and in a sense what is happening is that all of these elements are related and they pull together.

If in a sense you wind the string of one of them, namely, the initiation of deficit reduction, you will not get a decline in interest rates, you will not get the expansion in the economy which will generate the revenues which are implicit in the path that CBO has and you will almost surely end up with deficits which are either significantly higher or not higher solely because inflation has taken place and revenues are artificially expanded.

So I would say that the deficit path, the current services path of CBO is on the outside of all reasonable expectations and while one may want to use that for certain technical planning purposes, I would not forget that if you had a full spectrum of realistic prob-

abilities where current services deficit would end up, CBO's estimate would be on the extreme optimistic side.

The CHAIRMAN. Would you also comment on that, Dr. Blinder?

Mr. BLINDER. I think in large measure I would agree with the conclusion but would stress a very different reason. The main reason that CBO projects the deficit on a current services basis to decline to roughly half of what it is now is the assumption that the Congress will, for the next 5 years, allow the defense budget to grow at zero in real terms instead of the 5.5 percent real growth that it was using until recently.

If the Congress does that, and you all can guess better than I can whether the Congress will, then that is not an unrealistic projection of what the deficit will do. But I think a lot of people are skeptical that, in fact, the Congress and the President together will come up with a defense budget that grows at zero real for 5 years in a row.

The CHAIRMAN. Dr. Blinder, would you comment on what you think would be the appropriate economic growth assumption for the budget of the Congress?

Mr. BLINDER. For the next year or so?

The CHAIRMAN. For the next year, for 1987.

Mr. BLINDER. It seems to me, owing to the recent developments in the oil market—I want to enter a caveat to that in a second—a growth rate in the neighborhood of 4 percent is reasonable. I think you should read that as saying that 3.5 to 4.5 percent, or something like that, seems a realistic growth estimate. The caveat, of course, is that nobody really can sit here now and know what oil prices will do over the next 6 to 12 months, probably not over the next 6 to 12 weeks.

If the oil price is lasting, if it stays there for a couple of years, then I think projected growth of 4 percent or even more is a quite realistic possibility. If oil prices should snap back to where they were, then it is not.

The CHAIRMAN. Dr. Bosworth, what assumption of economic growth would you make if you had to make an estimate today for fiscal year 1987? What would you recommend that we utilize?

Mr. BOSWORTH. I would be slightly more pessimistic than Alan Blinder for the near term, but still in about the same range. Beyond 1987, I believe the Congress should be working with a target for GNP growth and then should hold the Federal Reserve to make sure we achieve it and I feel very strongly that the United States faces no inflationary threat, for example, in aiming for growth in the range of 3.5 to 4.5 percent a year.

I think unemployment in the United States is far too high at present and the emphasis on our economic policy should still be in the direction of strong expansion, not worrying so much that we may grow a little bit too rapidly. I think something in the range of 3.5 to 4 percent for 1987 is optimistic.

The CHAIRMAN. Dr. Greenspan, if you had to make an estimate today on what economic growth assumptions should be for 1987, what range would you put it in?

Mr. GREENSPAN. I would say for budget planning purposes, I would not disagree with 3.5 to 4 percent at this particular point. I

suspect it will be less, but it is really the type of forecast which I don't think should be employed in budget planning.

The CHAIRMAN. Let me ask you the same question, Dr. Greenspan, that I asked Dr. Bosworth. How do you feel about Treasury Secretary Baker's statement before this committee that being a net debtor nation is not a major problem, we are making productive investments as we did in the 19th century?

Mr. GREENSPAN. I must admit I agree with Dr. Bosworth. The evidence suggests that it is really quite difficult.

The threat, I might add, is quite a different one from what would have existed in the 19th century when we were on a gold standard and the real issue was either pay up or you default. Today's environment, the real threat of our external debt is largely to the U.S. dollar exchange rate and there is just no way that one can envisage the type of very substantial continued financing of the United States Federal budget deficit by foreign savings without getting quite concerned that what we are in effect doing is dissipating our resources and not producing capital investments, productive investments or anything that will pay back in a sense the loans.

The CHAIRMAN. Thank you, Dr. Greenspan.

The gentleman from Florida, Congressman MacKay.

Mr. MACKAY. Dr. Greenspan, I was privileged to hear you several weeks ago in New York and you made a brief comment at that time about a concern that things could go very radically wrong if foreign investors lost confidence in the U.S. dollar and for reasons that might or might not be foreseeable, we had a run on the dollar.

In view of the change in oil prices, do you still see that as a potential problem or something that you would be concerned about or do you see that as now sort of having resolved itself?

Mr. GREENSPAN. No; on the contrary, Congressman. I think that the decline in the oil prices, if anything, makes the problem worse, not better. The reason is that the essential key currency threats to the U.S. dollar are largely the deutsche mark and the surround currencies of the deutsche mark which are essentially countries with very little oil production and obviously the Japanese yen with almost—with, in fact, zero oil production.

As a consequence of that, the decline in oil prices has a very much more positive significant impact on those countries and, therefore, their currencies relative to the United States which obviously has a very substantial energy industry and clearly losses net on balance when the oil price falls.

There is a technical problem here of the relationship between oil consumption and the GNP and the size of the economy and one can exaggerate the negative impact that the oil price has on the dollar vis-a-vis the end, but I think the tendency is clearly in that direction.

But I am quite concerned that the issue of the exchange rate is not one of trying to get the dollar down because it is too high and creating problems. I think that was last year's problem. I think we are going to find that the 1986 exchange rate problem is going to be the reverse and that we are going to run into some potential difficulties of a dollar which is falling in a path that we find unacceptable.

Mr. MACKAY. That is essentially the concern that it seems to me Mr. Volcker expressed when he said he is worried about the problem of overshoot, I guess. It is uncontrollable once it starts falling.

Mr. GREENSPAN. I think it is quite an important concern. I don't think the issue, however, is framable in necessarily terms that there is a trigger point on the exchange rate which if you touch it, it unwinds a whole pattern of selling. I think the basic problem is that we are clearly evidencing difficulty in financing our current account deficit at the existing dollar versus other current interest rates.

In other words, the difference between the U.S. dollar denominated interest rates and others and at the current dollar exchange rate. One or the other is going to have to give and my suspicion is that most of the burden will be on a lower exchange rate to create equilibrium in the system.

Mr. MACKAY. Thank you.

Dr. Bosworth, you and I had a conversation a few weeks ago and you were expressing to me concern that the Congress might be lulled into thinking that these new projections we have gotten since last year reflect reality instead of just changes in budget techniques.

We have been trying to ask that question all week and have been having what I would consider to be very esoteric answers that our assumptions really haven't changed that much and they are very realistic and they are consistent. I don't know whether it is just that I am from the country and I have been taken a few times or what, but I am very suspicious about that.

I would appreciate your views on the question of whether this change in goals has come about because as former Under Secretary Roberts says, the doom and gloom days are over and nobody has got to do anything and it is going to go down to $100 billion or whether, in fact, we are being treated to some very esoteric accounting changes.

Mr. BOSWORTH. I think there has been a major change in assumptions but there has been absolutely no decisions taken by the Government that would say there is any more likelihood today that those changed assumptions will actually occur. I think the major changes are the ones that were mentioned earlier, the lower defense projection, imbedding of the first stage of Gramm-Rudman into the projections, and what I think is a rather silly forecast of interest rates.

But I think there are a couple other categories where there are some games being played with the cash budget. One of them in particular, which is discussed up here and in the administration, is to sell off financial assets.

Mr. MACKAY. That is the question we have been trying to raise. What is the impact of the sale of financial assets? I have told some of the members you have got the answer to that if we could ever get to you.

Mr. BOSWORTH. A sale of financial assets is simply a substitute for issuing more debt and it ought to be very easy for Americans to understand because they know in their own budgets if they try to correct an imbalance by selling off assets you can't continue that for very long.

There is no effect on the economy. There is no effect on national saving and rates of capital formation. It is a pure financial gimmick often used by private corporations and by the Government to make income statements look a little bit better for a period of time.

There is another gimmick that is often used to delay the payment of bills. No change in economic assumption, but if you just take the defense payments and hold back on the signing of checks for about a month, you pick up a heck of a lot of money, but, again, you have no effect on the economy.

If you will look in the budget projections, for example, of the administration, there is an increase in both of those two gimmicks being used in the basic budget projections and I think several people have in mind to rely on them much more heavily in the future in their efforts to get down to the deficit targets.

Mr. MACKAY. Thank you very much.

The CHAIRMAN. Thank you very much. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you, Mr. Chairman.

Dr. Greenspan, I wonder if you would agree with Dr. Bosworth's assertion earlier that we ought to finally agree that tax based incentives for savings investment have been a failure and we should try to find some other approach or certainly recapture some of that lost revenue for purposes of deficit reduction. I may be putting words in his mouth at this point, but certainly that assertion came through loud and clear.

Mr. GREENSPAN. I think the facts are unambiguous on this. The basic thrust of forms of saving policy using the Tax Code have essentially endeavored to create IRA's and equivalent types of vehicles which presumably would create incentives to put assets in certain types of tax benefited funds. We have seen huge amounts of moneys put into those vehicles and we have also seen huge amounts of moneys coming out of somewhere else to finance that.

You must remember that when you are talking about the issue of increasing savings, it is necessary to think in the obverse form reducing consumption as a percentage of income.

It is very difficult for the Congress to create anticonsumption vehicles but if you are going to try to increase savings the best way to do it is to reduce consumption.

In fact, the only way to do it is to reduce consumption and I think as Dr. Bosworth points out, the data unequivocally demonstrate that savings has not gone up in total and, therefore, one must conclude that all we are looking at is a transfer.

Mr. FAZIO. We have record losses of per capita savings in this country, as I understand it now, and clearly we are consuming a lot of the money. We are borrowing from overseas as the responses to Mr. MacKay make very clear. We have had a decline in our fixed investment. Certainly while the administration cites increases in our gross investment, the net is down quite markedly. Dr. Blinder, what do we do to improve the way our economy performs in terms of the Trade Office between consumption and savings?

Mr. BLINDER. I think the fundamental thing is just what we have been talking about this morning which is—and people have been saying this for years, indeed, maybe for decades—to shift the policy

mix toward a tighter fiscal policy, that menas a smaller deficit so the Government does not use so much of the economy's saving, accompanied by an easier monetary policy, so we have a lower interest rate environment, which is more conducive for business investment.

That is something we thought was desirable 20 years ago and 10 years ago. I think we still think it is desirable. We haven't done it, however.

Mr. FAZIO. Isn't it important we get other nations that we are currently competing with to take a more balanced approach to consumption instead of savings which I think is particularly the case of our relationship with Japan at the present?

Mr. BLINDER. That would be very nice for our trade account. There is a sense in which we are always going to have to have a fundamental trade imbalance with Japan as long as they are such big savers and we are such small savers. However, I think we are a big enough guy on the block that we can manage our own domestic investment despite that, through our own domestic monetary and fiscal policy mix. Hence, while it would be better if we had some cooperation with other countries, I don't think we need a large change in the fiscal-monetary policy mix in Japan in order to do that in the United States.

Mr. FAZIO. It is a copout to rely totally on other countries making changes in their policies.

Mr. BLINDER. Very much so.

Mr. FAZIO. Dr. Bosworth, we have talked a good bit about revenues already, some of it out of the earshot of the press, but more and more I think we are doing it publicly and we are focusing increasingly on oil or energy taxes.

Paul Volcker said 2 years ago to this committee that if oil prices fell below $25 a barrel we ought to impose an oil import fee. I think that at that time we had $31 a barrel oil.

We are recently seeing a number of economists with fairly broad perspectives, people who don't always agree with each other, arguing against using an oil import fee. Some argue for broader energy tax, some argue for gasoline tax dedicated to deficit reduction. Would you begin the commentary on what impact it would have on the economy were we to seize on this revenue source? What negatives would it provide for the kind of economic growth projections we have heard from all of you gentlemen?

Mr. BOSWORTH. I think your question made a crucial distinction, is it an oil consumption tax or broad based energy tax, or is it an import tax. If it is going to be an oil import tax, I think it is an outrage. It is the same as the automobile import quotas that were used to boost the profits of the automobile industry.

If, in effect, you put on an oil import tax in the United States that raises consumers' costs here by $25 billion, the Government will collect $8 billion of it, and the oil industry will collect the rest.

If you are in favor of an oil import tax, I would like to put in a bid to see if you would be willing to put a tax on imported economists because it might help me equally as much. I think all of us would like to see——

Mr. FAZIO. Things are that tough in the industry?

Mr. BOSWORTH. Things are tough.

Mr. MACKAY. Will the gentleman yield? I thought economists were like lawyers, the more you got, the more chaos there is, and thus the more you needed.

Mr. BOSWORTH. There is something to be said for that.

Mr. GREENSPAN. I think this conversation has gone far enough.

Mr. FAZIO. Soon we will be talking about laying end to end or something.

Mr. BOSWORTH. Let me finish by saying an oil consumption tax is not so bad. I think there are high social costs if Americans use more oil than they need to, that it impacts on the rest of us; and I think, as Alan Blinder was emphasizing, the decline in oil prices may be rather transitory in a long-term perspective and we may hate to see the end of the efforts being made to conserve on energy, and I think the important reason for that was high prices.

So I tend to be mildly supportive of an oil consumption tax. I don't think you can make a lot of economic arguments for that choice versus some other tax, but the key to preventing a tax from having distorting economic effects is to make it as broad as possible. Every time you hear proposals for narrow little taxes, you ought to think there is somebody in there who is going to benefit. The broader the tax, the better the tax.

Mr. BLINDER. I think I agree with everything Mr. Bosworth just said, but let me explain. I think if there is going to be an energy tax, it has got to be the consumption variety. There is simply no reason to pay two-thirds of the tax revenue over to domestic oil producers.

The question then becomes, well, should we tax oil or gasoline or something like that or something else. Is there some better way to raise revenue.

Now, one can argue for a tax on energy on the grounds that there is some kind of national energy security externality—that it is bad to be dependent on foreign energy supplies. We are less dependent now in 1985 than we were in 1975, and we can push that further by going the route of a broad-based tax on energy or oil or something. There is truth to that.

On the other hand, I must admit that I relish the possibility of having the reverse oil shock that now seems to be starting. We can do in the other direction some of the things that happened to us in the 1970's and in the 1980's. That is going to be a big aid to the economy and, to some extent, you unravel that by putting on a compensatory tax on imports.

So the question is, is there a better way to raise revenue. I think there is. I think the Treasury sent up to the White House—it got changed a little before it came down to the Congress, but still was fairly good—a fairly nice tax reform plan which would have closed loopholes left and right and made the income tax more efficient. Had they not been operating under White House constraints to raise the same amount of revenue, the tax bill could easily raise as much revenue as you like in a relatively nondistorting way.

So it seems to me that breaking the revenue neutrality constraint and going forward with some aspects of the tax reform bill is the best way to go. My second candidate—which doesn't quite have the revenue-raising capability, but if you are only looking for a small amount, it is a good one—is the tax on alcoholic beverages

which has been more or less the same in nominal terms since some time in the 1950's and has been reduced almost to nothing by inflation.

We can raise something on the order of $10 or $12 billion by putting these taxes back to where they were in real terms 30 years ago.

Mr. FAZIO. Dr. Greenspan?

Mr. GREENSPAN. I think you have to distinguish between an energy tax across the board, such as a refinery acquisition tax for oil and comparable taxes for coal and gas which embodies itself in the cost structure of American goods produced, and a tax which doesn't have that impact, say a gasoline tax, which while granted has some effect for gasoline use in business vehicles, essentially does not have the business cost-raising characteristics of an overall energy tax.

The impact of that which is very different to unwind, refund or adjust, is that it will continue to create a competitive problem for American goods manufacturer and probably as a consequence move the exchange rate down further to adjust for it.

It is not clear how the full context of that works out, but if there was some way in which we could find a mechanism to put a gasoline tax on which I understand over the decades is politically extremely different, that is a tax will raise revenues, very, very little negative economic effects.

I am fearful that an energy tax like any cost raising tax in the system has a very signicant amount of adverse effects.

I might also point out that the presumption that you somehow can pick up the wedge between the decline in crude costs and product costs in the oil industry and somehow tax that away and the consumer won't know the difference, that presupposes an unbelievable ability to somehow time a tax to get in that wedge before product prices become imbedded in the consumers' consciousness.

In 3 or 4 weeks, the lower gasoline prices will become a property right of the consuming sector and if you endeavor to put a tax back on it, they will view it as a tax increase and all of the notion that you are going to sneak it past the system I think will be lost.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Thank you, Mr. Chairman.

Dr. Greenspan, obviously policy as we set it here is generally determined by political reality, but if you were going to approach the budget problem and the deficit problem that we have at this point, would you think that the deficit problem could be solved by domestic spending cuts alone or should that deficit problem be solved by a combination of that also including restraint in defense spending as the President envisions it, should it include taxes, should it include restraint in growth of entitement programs like Social Security, for example?

Mr. GREENSPAN. Well, if you want to eliminate political considerations which begs the question, obviously I would say that we should endeavor to solve the deficit problem from the nondefense expenditure side. My own personal sense of where the relative values are in the cuts and the benefits I think that it is a mistake

to leave Social Security and the entitlement programs out from any cuts.

I think raising taxes is undesirable if we can restrain expenditure growth because I am concerneed that tax increases will not in the long term have the same impact on deficits as expenditure cuts. I do think that the defense budget is a very different one to deal with on the grounds that I don't know how to get a handle on what is the appropriate defense budget issue.

I do know that it should not in principal be keyed to budget requirements. It is a national security question and whether it is large or small shouldn't really be involved in the budget debate. My suspicion is that it is too high but that has got nothing to do with the budget question. That is just that I have seen too much in the way the system functions to believe that that is how much we have to spend to get the amount of security which we are currently getting.

So I conclude that as far as the appropriate piorities are concerned that I fault the President's budget not in the sense that he has got all of the deficit reduction essentially in the nondefense area, it is the fact that he excludes from the nondefense area things which I don't think should be excluded.

Mr. LEATH. Dr. Blinder, could you address that question?

Mr. BLINDER. I will be glad to. I did address that briefly in the written testimony, but didn't get a chance to talk about it. I appended to the back of the testimony a column I published in Business Week a month or so ago which suggested basically that the required deficit reductions were not so hard, even politically I suppose, to accomplish as long as the base for deficit reduction was kept as broad as possible. And that includes the things that you mentioned. It includes raising taxes; it includes Social Security and entitlements; and it includes defense as well as the part of the budget that the President would like to cut.

I suggested doing something like half the deficit reduction on the tax side and half on the spending side, and then dividing the spending part into thirds. The budget is roughly divided into three equal parts—a third is Social Security and Medicare, a third is defense, and a third is everything else—if we forget about interest. We can't cut that in a discretionary way, anyway. So taking the half that is to come out of spending and dividing it into a third, a third, and a third on those three categories seemed to be a relatively appealing pain-sharing formula, if you care to call it that.

If you accept the kind of deficit reduction target that I was suggesting in my testimony a few minutes ago, the required cuts are not that large. I suggested that something on the order of total deficit reductions of $24 billion a year for 3 years, and then stopping would get us roughly where I think we ought to be.

When you start dividing that half into thirds, you are not talking about a lot of money. But the key there, as you suggested in your questioning, is to keep the base broad, not to narrowly focus on a small piece of budget.

Mr. LEATH. Dr. Bosworth?

Mr. BOSWORTH. I would start by saying that from an economic point of view, I don't think how you go about it makes a heck of a lot of difference. I think the economic issue is you have got to pay

for what you get. That means to get the deficit down. When economists start to tell you how they want to get the budget deficit down, you are just listening to us as private citizens. We have got our own ideas: Cut the other guy's programs and don't cut mine.

It is very hard to go beyond that. I guess I would rather propose that the Congress in some respects has to look at this a little bit differently. I think what has been going on now for 5 years is everybody comes forth and says keep my program, cut the other guy's program. That is not going to get you anywhere. Instead, I think the model for this ought to be exactly what the Congress did in 1983 with Social Security.

You sat down and you looked at what you thought the benefits of that program were, and you decided to both cut benefits in the future and increase taxes. In other words, you did both, but you did it by going through program by program, matching benefits and costs at the level of an individual program.

If you take all the rest of the budget, you can do the same thing. I admit it is arbitrary, but take the deficit and just spread it over all the programs in proportion to their share in total expenditures. I would say defense is responsible for half the budget deficit.

Is this level of defense spending necessary? If you answer the question yes, then vote the tax increases to pay for that program. There should be, in other words, a matching up of benefits and taxes program by program.

In respect to doing that, I guess I don't understand why Social Security as a program has to take another hit. The program is already being misused by taking a surplus generated by taxes on low-wage workers and using it to finance defense. I don't see why you want to do more of that. If you wanted to save the surplus, that is a different matter, but if you just intend to cut Social Security benefits and then take the surplus in the Social Security fund and turn around and finance national defense, I think I object.

I don't understand why only low-income workers ought to pay for national defense. If you want to cut Social Security benefits and match it with a tax reduction, that is a political action you could take, but I don't think that the Social Security fund is intended to be just a general source of revenue. It is not the way it is set up, it is not the way it is explained to the American public.

I think it is a separate issue. I prefer you going through program by program and adjusting that program's benefits or increasing the taxes to pay for it, not trying to use this excuse of shifting funds from one accoiunt to another as a way to camouflage the total budget deficit.

Mr. LEATH. Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Bosworth, I just want to understand a response you gave to the gentleman from Texas. You said you believed half of the present deficit was from defense spending.

Mr. BOSWORTH. I think just in terms if you look over the growth of expenditures in the 1980's and the rise in the budget deficit, anybody trying to come up with some estimate of where it has all come from, assuming that the tax reductions accrued to all the programs, you would have to say defense is something like half of it. That is our big expenditure buildup.

Now, as a economist, my only point is I have no basis for telling you whether or not that national defense buildup is necessary, but you do have to pay for it.

The CHAIRMAN. I understand what you were saying. It is a political decision as to whether you want to do that, but the debt issue is the one I wanted to clarify.

The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. Blinder, I was interested and appreciate your comments on the Gramm-Rudman targets and your brief—because you are trying to be brief—comments referring to perhaps an opportunity for perhaps something that would be a better target. I think you referred to structural deficits; am I correct?

Mr. BLINDER. Yes.

Mr. LOWRY. Would you tell me first briefly what your definition of a structural deficit is, how we would identify that figure and how you would see that working as a target?

Mr. BLINDER. Structural deficit estimation is something that is done both at the OMB and CBO. It is an estimate; let's be clear about that. It is an estimate in the broader sense that the whole budget is always an estimate. They don't have every nickel and dime counted exactly. But it is also an estimate in a different sense, in that one has to estimate, first, the level of economic activity and all the things that go with that—such as the level of corporate profits and wages and things like that—that would correspond to what we think is an appropriate high employment target.

People nowadays tend to use 6 percent or something like that. One can't be exact about this. The number I carry in my head is 5.8 percent, but that means a number between 5½ and 6 percent.

In any case, you develop an estimate of what the budget would be if the economy were operating at an unemployment rate of 5.8 percent plus or minus, something like that. You call that the structural deficit.

The other suggestion I made was to also do the inflation accounting correction on that structural deficit. But you can think of that as a logically separable issue. I am still not in favor of the Gramm-Rudman approach even as a structural basis. But a great improvement on that approach would be made by setting down the 5-year targets in terms of the structural deficit—which would, of course, mean the deficit at an agreed upon level of unemployment—instead of setting down targets for the actual deficit. Then we could let the actual deficit go above or below the current Gramm-Rudman targets according to the performance of the economy, which is something nobody can predict 5 years in advance. That is the kind of thing that I had in mind.

Mr. LOWRY. I, myself, think that makes a lot of sense.

Would there be a broadly agreed upon estimate of what that would be because to get around our political problem here we are working in this bumper strip economics and so there has got to be a way to put it on the bumper strip that we did something? Would there be agreement among economists that we were using a correct rather than a phony target?

Mr. BLINDER. I think you could get fairly broad agreement among economists. That doesn't mean everybody will sign on to a

range of what I just said, 5½ to 6 percent. There will be some disputes on either end, and your political sense will predict correctly for you who will dispute which end.

So we are not going to get 100 percent agreement. But picking a full-employment target is exactly the sort of thing that a congressional committee can do. You can envision a congressional committee taking expert opinion and then sitting down and saying to itself, we have the ultimate authority for this. Given what we have heard, we have to decide.

I do think that the vast majority of professional economists would come in with an estimate in the range I said. That won't give you an exact number, but it will put you in the ballpark.

Mr. LOWRY. Mr. Bosworth and Dr. Greenspan, I want to ask you a question relative to the Federal Reserve policy. Apparently the Chairman of the Federal Reserve has, in the last couple of days, expressed a reluctance to see the dollar fall further apparently because of inflation fears. I thought we all wanted to see the dollar fall further and I think some administration spokesmen are stating that.

Do you think that the Federal Reserve Chairman's reluctance to see the dollar fall further is warranted? Do you agree with that or what do you think our policy should be on that?

Mr. BOSWORTH. I read the transcript of that. It was so jumbled up, I am not too sure exactly what he meant to convey. i think there is a very real concern that the chairman has that other people ought to be aware of. This foreign exchange market is dealing in billions and billions of dollars and a lot of people are making a lot of money. You do not want to get in the position where you create, in effect, a one-way bet by guaranteeing people that you are just going to let the exchange rate go down any more than you want to guarantee them it is going to go up.

I think Government officials in positions of responsibility like that should say that they are not in the business of predicting future movements in exchange rates and not try to influence the market in any way.

There were some earlier statements from the administration. I remember a former Secretary of the Treasury who got in a lot of trouble because he talked down the dollar; and one interpretation is that it was an attempt to balance the prior remarks.

In the long run we know the dollar has to come back down if the United States hopes to compete in world markets, but that doesn't mean you want to get in the business of predicting the rate at which it is going to come down or how much it is going to come down tomorrow because that can have a very disruptive effect on markets.

Mr. LOWRY. Mr. Greenspan, would you comment on that same question on the Federal Reserve?

Mr. GREENSPAN. No; I think that Chairman Volcker was expressing in public what has been expressed in private, expressed by other members or the Open Market Committee in private. It is a general concern. I think that the behavior of the dollar in the exchange markets is turning weak.

We are observing very inconsiderably increasing difficulty, as I indicated before, in financing our current deficit at the existing ex-

change rate. There is no evidence yet of any actual selling off of already accumulated dollar denominated assets by foreigners, but there is clear evidence that their willingness to absorb dollar investments at the rate required to finance the current account deficit is declining and in that sort of long-term environment I think Chairman Volcker expresses concern that if superimposed on all of that, there is a swing in the desire of those who hold assets to disgorge them, then you begin to get a disruption in the domestic money market largely because you are withdrawing funds from the system and that in turn could create upward pressure on interest rates and accommodation requirements by the Fed which they feel quite concerned about.

I don't think it was a flip remark. I do agree with Dr. Bosworth that it is the context in which it was stated. It is always somewhat ambiguous but I think that Chairman Volcker stated on one of the few occasions that I remember in public some policy forecast issue which he really believes in.

Mr. LOWRY. Thank you.

The CHAIRMAN. The gentleman from Montana, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Dr. Bosworth, earlier I believe in a discussion about options on how to decrease the deficit or perhaps near a balanced budget, you said that generally from a purely economic standpoint, it didn't make much difference how we achieved these results. You then later expressed your own personal objections based, I guess, on political judgment, that it was not a good idea to cut dollars from low-income people and retired persons, particularly if we are only going to add them to the defense budget.

But the fact is that Congress has operated under the assumption throughout the years that indeed it does make a difference; that a dollar spent assisting a young American to go to college has a much different return to the Treasury than a dollar spent keeping a trooper in Europe under NATO.

The Congress has assumed that a dollar cut from a Social Security check has a different economic effect than a dollar cut from NASA. Speak to that assumption of ours in the Congress.

The CHAIRMAN. Before you begin to answer that question, I think Dr. Greenspan has to leave, members of the committee, and I would like to be able to excuse him at this time because I know he is rushing to catch a flight.

Thank you, Dr. Greenspan, for being present. We appreciate your testimony, and it is always good to see you here in Washington.

Mr. GREENSPAN. Thank you. I apologize for having to leave, but I had a pressing, urgent earlier engagement.

The CHAIRMAN. We will never forgive you, and we will put that import tax on economists.

Go ahead, Mr. Bosworth.

Mr. BOSWORTH. In terms of short-term effect on the economy, I don't think there is a significant difference. To a first approximation, I think they are equal.

Instead, I think you just get into a different issue, which is, what are the social benefits of a particular type of Government program. When you send someone to school, you think that has got a high priority because there is going to be, so to speak, some human cap-

ital accumulated. It is an investment, and the country will receive a return from that in future years.

When you invest, I suppose, in the retirement check of an elderly person you get no future income gain like that. But you do it because you think it humane. It has an obligation to maintain its elderly at a certain level of income. Those are just different benefit judgments.

I would agree that education outlays have an economic return in the long run that is different than, say, spending on Social Security.

Mr. WILLIAMS. What do you mean by the long run; 20 years, 5 years?

Mr. BOSWORTH. 20.

I don't think you look for any near-term returns to investment in human capital. I think you are talking about a long-term process of higher education levels directing people into more research and development, a somewhat faster rate of technological rate than you had in the past gradually being incorporated by American industry and production processes.

You are talking about a very long process with most types of capital formation before it shows up with benefits. By the same token, the failure to invest in the 1980's is not going to show up for several more years in any terms of loss of income to Americans.

Mr. WILLIAMS. Of course, this Congress, as with Congresses 20 years ago, does make its judgments based on what will happen in the 1990's and beyond. Therefore we cast our votes and make our decisions based on both the short term and the long term, as I am sure economists would have us do.

Dr. Blinder, I don't know if it was you or Dr. Greenspan who mentioned that certainly one way to increase savings was to decrease consumption. Assume we can also decrease consumption by increasing taxes. Would that increase savings?

Mr. BLINDER. I think it definitely would. It won't increase private savings. But we are interested in national savings. Private individuals save; businesses often save net of their investments, though sometimes they don't; and the Government usually dissaves some of the private sector's savings.

So, you can think of private individuals, and to some extent the business sector also, pouring savings into the capital markets, the Government taking some of it away through its dissaving, and the rest going into business investment—ignoring for a moment the role of foreigners.

If the Government raises its taxes, people will spend less. The Government's dissaving will go down, which is the equivalent of Government saving. The Government is basically taking money from private individuals when it raises income taxes, saying you are not going to spend 94 or 96 percent of this—which is what individuals typically do—the Government is going to take it and save it all. That is what happens if the Government applies the tax revenues to deficit reduction—not to further spending.

So, the surest way, as Mr. Bosworth said earlier, to raise the national savings rate is to reduce the Government dissavings rate. That is what a tax increase would do.

Mr. WILLIAMS. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from South Carolina, Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Dr. Blinder, Dr. Bosworth, it is nice to have you before the committee.

I am not exactly sure how I feel about it. I agree with most of what you say, but I will have to say over the last week or so of testimony, even though I didn't agree with most of it, I was hoping that maybe some of it might be true, and you sufficiently dashed those hopes this morning to leave me with a rather pessimistic attitude, which I rather thought was true to begin with.

Be all that as it may, I am a cosponsor of some legislation, as I think a number of others are in the House, to take the Social Security trust funds and make them independent of the integrated budget, which, of course, would no longer allow us to figure that surplus that we use then.

If we did not use the surplus funds, how do you see that affecting our budget deficit as projected? Is my question clear?

Mr. BLINDER. I think so. In an accounting sense, the trust fund——

Mr. DERRICK. I am sorry. Either one of you, or both of you.

Mr. BLINDER. Taken by themselves, the Social Security trust funds will be running a surplus for the next quite a few years. And so on balance, if you were to take the trust fund out of the budget the apparent accounting deficit in the budget would be bigger by the amount of the surplus in the Social Security trust fund.

Maybe I didn't understand your question.

Mr. DERRICK. We are using that surplus in the Social Security trust fund by financing these other programs, and therefore we are not showing a realistic deficit. Is that correct?

Mr. BLINDER. Yes; but I think it is mainly an accounting question rather than an economic question. In toto, the Government does a certain amount of spending, some of which is on Social Security benefits, and lots of which is other things. In toto, it takes in revenue, some that goes to the Social Security trust fund, most of that doesn't.

Mr. DERRICK. Those Social Security trust funds are not income. I mean, as I understand it, they belong to the trust fund. And although I understand that it is an accounting procedure, the trust funds in turn on that go to the general revenue for the Government to use for whatever their purpose is. Therefore, what that does is just create additional obligations against the Government.

What I am trying to get around to is, even though it may be an accounting matter, are we—would it be truthful to say that we are not really projecting a true deficit figure when we are talking about $200 billion, or whatever the—if we took those Social Security trust funds out of there, it may be $300 billion, $400 billion; is that correct?

Mr. BLINDER. It is correct in an accounting sense. But I think in an economic sense the Government affects the economy through both its non-Social Security activities and through its Social Security activities. That, I guess, is why what we used to call the unified budget back in the sixties took these trust funds in.

Mr. DERRICK. They don't take them in now?

Mr. BLINDER. We have just changed budget terminology and people like us are getting tonguetied as a result. We used to define the unified budget to include the trust funds. Now I am told we are supposed to use the term unified budget to denote the budget exclusive of the trust funds. I think that is proper nomenclature.

Mr. DERRICK. The $200 billion figure, we are not using the Social Security trust funds?

Mr. BLINDER. It does, I believe. It does include the trust funds.

Mr. BOSWORTH. Everything you have been given by CBO and by OMB when they talk about the budget deficit, and all the numbers you have been focusing on are a budget inclusive of Social Security trust funds. That trust fund is presently running a deficit of about $15 billion a year, and it will rise to between $60 and $65 billion a year by 1991. So, the deficit you are looking for would today be about $15 billion larger than now reported, and by 1991 it would be $60 billion more than being projected.

Mr. DERRICK. Let's get back to this. I was very pleased to hear it, although I wish it wasn't true, your comments, because we had Secretary Baker before the committee yesterday and I asked him two questions—one about the trade deficit, which he kind of poohpoohed and said, well, you know, it wasn't any big problem that we were a debtor nation, and that has been gone into before.

Another question I asked him—my scenario was, you know, who had a $29 billion deficit or $29 to $39 billion, somewhere in that area, back in 1979, and that now we had a $200 billion deficit. The administration was taking credit for all this grand recovery that we have had with these jobs that have been created and economic activity and so forth and so on.

I asked him if he thought that the $200 billion, that had been going in and borrowed money every year into the economy, was a tremendous part of that, or had any stimulus effect. And he indicated to me he thought it had very little.

The reverse of that question is if, in fact, we proceeded along the lines of Gramm-Rudman-Hollings—I have to mention Hollings since he is from my State—is the reverse of that going to be a disincentive or disstimuli? Dr. Bosworth.

Mr. BOSWORTH. Yes; the reverse of that will be. That is why earlier this morning we emphasized so much the need for the Federal Reserve to change its policies to offset that effect on the total economy, so that this action is in the short run going to have a depressive effect on the economy. In the long run, it will be extremely beneficial because it will drastically increase the national rate of saving and capital formation and raise our national income in future years. But that is very far in the future.

In the short run, it is depressive and it is critically important that the monetary policy change so as to offset that effect.

Mr. DERRICK. But this deficit has been a tremendous stimulus to the economy, though, over the last 4 or 5 years, hasn't it?

Mr. BOSWORTH. Ronald Reagan has been the greatest Keynesian in history.

Mr. DERRICK. That was my point. I liken it to, if you want to give me one-half million dollars a year and tell me I can just pay the interest on it until I run out of funds, and the interest amounts to more than I have got coming in, I can have a merry old time. That

is kind of where we are right now, as I perceive it. Thank you for your testimony.

One of the members just said a minute ago you know these hearings do become tremendously stimulating sometimes, and I think you three have been the best witnesses that we have had, not necessarily so much that I agree with what you say, or think it is realistic what you say, but I think you have really been very candid with us and very straight, and I thank you very much for it.

Mr. BLINDER. Thank you.

The CHAIRMAN. I thank the gentleman from South Carolina. His time has expired.

The gentleman from Florida is seeking additional recognition. The gentleman from Florida, Mr. MacKay.

Mr. MACKAY. I just have one question, Mr. Chairman.

I am asking this, and I really don't know the answer. I have read recently in some private sector economic forecasts that the amount of currency transactions internationally is on the order of magnitude of several times the volume that would be required just for international trade, and that in fact you have to end up concluding that there is a huge amount of speculation in the international currency markets at the present time.

Am I correct in the way I have read that? And if so, does that cause any concern? Does that complete the loop if you are trying to see what is happening now as compared to 1929, and you say, well, we used to have the speculation on our internal markets; now we have got it internationally and it is really an international economy?

Mr. BLINDER. I think there is truth to that. We still have it on our internal markets, as we all know by reading the stock exchange reports daily. Movements of international moneys don't only finance movements of goods, which is what you are referring to; they also finance movements of assets.

Americans buy stock in Tokyo. Japanese buy stock in the United States, and bonds of General Motors, and all sorts of things like that. All of that requires international moneys to move. So, some of the difference you were citing between the huge volume of international currency movements and the much smaller trade flaws is genuine; its either real investment in physical assets or financial investments in stocks and bonds.

Then, another share—and I have no idea how to parse this out between the two—are these very large speculative movements that are bouncing around from day to day. When you put those two together, you get a shuffling of currencies across national borders that is a big multiple of the trade flows.

Mr. MACKAY. That if you are looking at the concerns that Mr. Volcker is expressing—I personally heard him express this same concern a year ago; I don't think he is saying anything now that he didn't say last year—with that kind of speculation going on, it has got to (a) concern him, and (b) it should concern us when we look at these projections that interest rates are just on this gradual—the doom and gloom days are gone, everything is going to be all right, interest rates are going to go down.

If we start having anything that could even be characterized as the beginnings of a run on the dollar, a softness, interest rates are going to go up. Am I correct in that assumption?

Mr. BLINDER. Yes; I think that in the event of a run on the dollar, or what the Federal Reserve perceives to be a run on the dollar, the Federal Reserve will revert to the traditional position of central bankers for centuries, which is to jack up domestic interest rates to protect the currency. I have little doubt that they would do that.

Mr. MACKAY. What I am saying is, in an international situation such as we have got now, it is not a question of whether they want to. I don't see any other way to deal with it. In other words, I think they have run out of options and they have been driven into this position because of our refusal to exercise fiscal discipline.

The idea that we can somehow use monetary tools further, I don't think there are any more rabbits in the hat.

Mr. BLINDER. I have to agree with part of that. The part about the lack of fiscal discipline, I agree with. But I still think there are some rabbits Mr. Volcker could pull out of the hat.

Mr. MACKAY. In the event there was a run on the dollar, what would you do? The choices would be to what? Print money or allow interest rates to go up?

Mr. BLINDER. Not to print money. The concern then would be how much should the Fed tighten up in order to preserve the value of the dollar. And my inclination would be, not very much.

I think his inclination, that is the Board's inclination, would be to tighten up a good deal. The tradeoff you will then have is between the external value of the dollar and the internal state of the U.S. economy—because the way a central bank protects its currency is by jacking up interest rates and causing a domestic recession, more or less.

That is what the IMF runs around the world telling less-developed countries to do. And the same advice will be given to the United States by its own central bank.

But there is a choice. It is not that it is inevitably either a recession or a currency collapse. You have a choice. At least we do. We are a big enough country we have a choice.

Mr. MACKAY. You are saying we could allow foreign investment to go out of here——

Mr. BLINDER. Yes.

Mr. MACKAY [continuing]. And not, at the same time, balance our budget, and that would not then put us directly in the quandry of the crowding out syndrome which would raise interest rates?

I honestly don't see any option. It seems that is what is going to happen.

Mr. BLINDER. You are right about the way this plays out. All I am saying is that the Federal Reserve, through its monetary policy, has a choice about how much of this problem is going to play out in the foreign currency markets by the dollar falling and international currency flowing out, and how much is going to play out internally by moving our domestic interest rates up and affecting economic activity in the United States.

There is a whole continuum of choices there. That is the point I am trying to make.

Mr. MACKAY. Thank you, Mr. Chairman.

The CHAIRMAN. We want to thank both of you gentlemen.

Did the gentleman from California have any questions?

Mr. FAZIO. Yes, Mr. Chairman. I have one question I wanted to ask at this time.

The CHAIRMAN. Forgive me. The gentleman from California seeks additional recognition. Mr. Fazio.

Mr. FAZIO. Thank you very much. I want to join with Mr. Derrick in the expression of appreciation on behalf of the whole committee for a very stimulating session.

Dr. Bosworth, you have suggested that long-term budget policy aiming at a surplus might be healthy somehow. You want to increase capital formation, reduce the burden of funding retirement in the future, and perhaps simplistic or naive Keynesian theory would raise the question of whether this policy would be too restrictive holding down employment and growth.

Do you think there would be a demand problem if we adopted it, or could the economy make the required adjustment to higher savings and investment with full employment? How do we make this adjustment?

Mr. BOSWORTH. In the short run, I think there is definitely a demand problem. If you suddenly cut the budget deficit, I just don't think the rest of the economy can adjust fast enough. In the long run, I do not believe that is true.

I guess I would give you in the long run I believe there is an infinite combination of fiscal and monetary policies that will all produce exactly the same level of output. All you are really talking about, if you are going to have a surplus in the Government budget you then must find some means of stimulating enough private investment, home building, inventories, automobile purchases, business investment.

While I think we have a very optimistic outlook on that side and need a lot more investment, we should be doing that, and we are not.

One area would be, the post-war baby boom is exactly of the age they, too, would like the chance to buy a house. I don't see anything unreasonable about giving them that opportunity. So, I think residential construction could absorb a lot of this increased savings.

Second, I am a little bit appalled that the richest Nation in the world has become the world's largest debtor Nation. I thought wealthy countries were supposed to be willing to devote some of their resources to invest in less-developed countries, like was done for us 100 years ago, and came up earlier.

Third, I think if you have a low enough structure of interest rates and good prospects for rapid growth in the future, you can get very high levels of business investment. We have been notable in this country for decades of having a much lower rate of business capital formation than is true in other industrial countries. I don't think that is something that is handed down from heaven. I think it is a choice we make in our economic policies.

I agree it really does require the cooperation of a Federal Reserve, and when I listen to their public statements I get very nervous. But, as a concept, I think that we should have a higher rate of capital formation in the United States. The data show society earns

an extremely good rate of return on capital investment. Broadly defined, research and development, human capital should all be included in that.

But capital investments is a darn good investment for society, and I think we ought to do more of it.

Mr. FAZIO. A coordinated economic policy and a gradual approach, it would work.

Mr. BOSWORTH. Yes.

Mr. FAZIO. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. We want to thank our witnesses today, Dr. Alan Greenspan, who had to leave earlier; Dr. Blinder, and also Dr. Bosworth. You have been very informative and very candid with us. We certainly appreciate your taking time to come and share with us your thoughts and projections on this very important subject as we continue our work. Thank you again, gentlemen.

The committee will recess until 1:30 o'clock.

AFTERNOON SESSION

The CHAIRMAN. The committee will now come to order.

This afternoon we are privileged to hear from Benjamin Hooks, president of the National Association for the Advancement of Colored People, and John Jacob, president of the National Urban League.

John Jacob and Benjamin Hooks are two of the most distinguished black leaders in our country. Each is head of an organization with a long and distinguished history of fighting for social justice and racial equality.

We have asked both these gentlemen to provide us their views on the administration's budget proposals for fiscal year 1987. It is appropriate Mr. Jacob and Dr. Hooks appear before us the day after we heard from the Secretary of Health and Human Services, Dr. Otis Bowen.

Dr. Bowen testified that none of the problems with which his Department deals concerns him "more gravely than the status of the American family." Dr. Bowen correctly noted that these problems strike hardest at the black family—a conclusion which parallels data this committee was given by Marian Wright Edelman, the director of the Children's Defense Fund, in her appearance before this committee in Chicago last week.

Tragically, the Reagan administration's response to the plight of the black family appears to be yet one more welfare reform study. In his State of the Union Message, the President called for such a study. While once more welfare is being studied—which has become a form of income support for economists over the past two decades—the President's budget calls for actual programs to be cut.

Cutting programs, while studying the problem, occurs at a time when evidence mounts that in the economic recovery which this man so proudly proclaims, black Americans risk a return to "The Invisible Man" of Ralph Ellison's book.

In Chicago, Marian Wright Edelman told us that a black infant is more likely to die in that city in the first year of life than an infant born in Cuba or Costa Rica.

The gap between black and white unemployment has widened by more than than 2 percentage points since President Reagan took office. This dry statistic translates into 238,000 more blacks being unemployed. The difference between black and white family income has widened since this administration took office.

I welcome your comments on what the budget which the President sent to Congress earlier this month means for black Americans. I also hope that they will direct their comments not only in terms of the impact on minority America, but also the impact of the President's budget upon families, upon workers and other persons who are in the lower income strata and the lower middle income strata. Also, what this fiscal policy and budget priority means in terms of keeping doors of opportunity open for Americans of all races and all creeds to be able to achieve the American dream.

We welcome Dr. Hooks and Mr. Jacob. We will begin with Dr. Hooks. Let me say that your testimony in its entirety will be submitted for the record. Feel free to summarize your statement so that we may proceed with questions.

STATEMENT OF BENJAMIN L. HOOKS, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE

Mr. HOOKS. Thank you, Mr. Chairman and members of the committee. I thank you for this opportunity to testify today on the fiscal year 1987 Federal budget.

At the outset, the NAACP is not opposed to deficit reductions nor to balancing the budget. We, in fact, favor it. In 1981, we submitted to the President and the Congress a document entitled "Alternative Policies in the Public Interest for Economic Growth." We identified major issues and recommendations to combat unemployment, inflation, and inner-city problems. The summarized policy statement is appended to my statement today for the record and I will not discuss it now.

I am happy to be here as executive director of the NAACP, an organization that has existed since 1909. Overall, since 1981, the economic status of black Americans has declined. Poverty in our community has increased and unemployment has risen and stagnated at unacceptable levels.

In short, the economic recovery so touted by this administration has passed us by. We have been left out of the economic recovery of American society and from this perspecitve we also wish to examine the Federal budget and the policies embodied therein.

We have to humanize the mass of numbers and the calculations in the budget process, for we are disproportionately represented as blacks among the poor in America.

Of the 34 million Americans officially considered to be living in poverty, blacks comprise 25 percent, and thus are more dependent upon Federal aid for survival. Yet, in the eighties, the average Federal benefits have declined, in some cases sharply, after adjusting for inflation.

Examples are the average AFDC benefit which dropped 15 percent during the period 1979 to 1984. Typical food stamp allotments

fell 11 percent and housing assistance was worth 25 percent less to recipients.

The impact of Federal aid to the poor can be measured by how many people were raised from the poverty level as a result of the major welfare programs. In 1979, the combined benefits from these programs boosted 27 percent of the poor above the poverty level. That figure dropped to 21 percent by 1981 and 17 percent in 1984.

A full 39 percent of those living below the poverty level received no aid at all. They simply fell through the many holes in the so-called safety net. In fact, there has been a 41 percent increase in the number of poor people since 1979.

It is against that backdrop that we view the administration's budget and it is not a pretty picture.

Domestic programs are reduced by $23 billion, a 12-percent reduction in employment and training programs, a 15-percent reduction in education programs, a one-third reduction in housing programs, a 12-percent reduction would be achieved by cuts in the Medicare program while simultaneously increasing costs to be borne by the elderly and the poor; 2.3 million students eliminated from student assistance programs; elimination of the Legal Services Corporation; and elimination of the Community Services Block Grants.

These, Mr. Chairman, would be viewed against a backdrop of an 8-percent real growth in defense spending, including a 75-percent increase in the so-called Star Wars system. The fact of the matter is that the executive board of the NAACP has passed a resolution calling upon the Congress to reject the President's budget.

The message I wish to bring today is that in order to effectively reduce the deficit, it is necessary to look at the causes to engage in basic problem solving, if you will.

It is apparent that the economic policies of the past 5 years have contributed greatly to today's budget deficit. The Nation was promised that tax cuts plus increased defense spending and elimination of fraud, waste and abuse in domestic spending would lead to additional revenues to the Federal Treasury and a resultant reduction in the deficit.

We know now that is not true. Instead, what has happened is an accumulative deficit over the past 5 years equal to that of all prior administrations since from Washington to Carter.

The Congressional Budget Office has estimated that the 1981 tax cut reduced revenues for fiscal year 1986 by $208 billion, nearly equal to the $220 billion projected deficit. The NAACP strongly urges you to not only reject the President's budget, but to develop an alternative that addresses the real causes of the deficit.

Corporations and high-income individuals received windfall reductions in the 1981 tax cut, whereas after-tax income fell for low-income individuals as a result of that cut.

Defense spending includes undue waste. Considering this, we do not believe that doubling the defense budget is justified and we further feel that there is real room for significant spending restraints in this area.

It is clear that what has occurred in the past 5 years is not a reduction in Federal spending, but a redistribution of spending accompanied by massive reduction in Federal tax revenues. Yet, the

administration continues to blame domestic spending for the deficit and it is time that we put that misinformation to rest.

Domestic spending has been blamed for the deficit and the burden of cuts to reduce the deficit has been thrust unequally on the back of domestic spending.

Mr. Chairman, our Nation cannot afford to continue these failed policies. We must provide for our poor, our elderly, our disabled, our sick, our unemployed and our youth. We must view education as an investment in our Nation. To do otherwise will make us morally bankrupt.

I thank you for the opportunity to appear and testify before you and this committee. If there are any questions, I will be glad to try to respond recognizing that Mr. Jacob kindly relinquished his spot so I might catch a plane earlier than his.

[Testimony resumes on p. 538.]

[The prepared statement of Mr. Hooks follows:]

PREPARED STATEMENT OF BENJAMIN L. HOOKS

Mr. Chairman and members of the Committee, I am Executive Director Dr. Benjamin L. Hooks of the National Association for the Advancement of Colored People (the N.A.A.C.P.), the nation's oldest and largest civil rights organization.

I thank you for this opportunity to testify today on the president's proposed federal budget for fiscal year 1987.

At the outset, the N.A.A.C.P. is not opposed conceptually to deficit reductions and balancing the budget. We in fact favor it. In 1981, we submitted to the president and the Congress a document on "Alternative Policies in the Public Interest for Economic Growth." We identified major issues and recommendations to combat unemployment, inflation and inner city problems. The summarized policy statement is appended to my statement for the record and I will not discuss it now.

Since 1981, the economic status of black Americans has declined; poverty in our community has increased; and unemployment remains high. In January, the total civilian rate of unemployment among Americans "willing" and "able" to work was 6.6 percent; yet, among blacks the unemployment rate was 12.8 percent. Among black youths age 16-19, the rate was 38.6 percent or up to 40.2 percent. I re-emphasize "willing" and "able" to work in view of historical observations that blacks have worked to lift themselves up by their own bootstraps. We believe in and practice the American "work ethic."

Nevertheless, income levels among blacks still lag behind comparable levels for whites. The real income for black families was around $13,989 as compared to $25,836 for white families, as found by Joint Economic staffers, based on 1984 statistics. This is mere evidence that the economic recovery so touted by this administration has passed black Americans by. We have been left out of the economic recovery of American society and from this perspective, the N.A.A.C.P. examines the federal budget and the policies embodied therein.

To start, it is essential that we humanize the mass of numbers and calculations in the budget process.

Blacks are disproportionately represented among the poor in America. Of the 14.4 percent or 34 million Americans officially considered to be living in dependent upon federal aid for survival.

Yet, in the 1980s, average federal benefits to provide minimum income, food and shelter have declined, in some programs sharply declined, after adjusting for inflation. Examples are that:

- the average AFDC benefit dropped 15 percent during the period of 1979 to 1984;
- typical Food Stamp allotments fell 11 percent; and
- housing assistance was worth 28 percent less to recipients.

The impact of federal aid to the poor can be measured by how many people were raised from the poverty level as a result of the major welfare programs. In 1979 (before Reagan) the combined benefits from these programs boosted 27 percent of the poor above the poverty level.* That figure dropped to 21 percent by 1981 and 17 percent in 1984 by the end of Reagan's first administration.

However, a full 39 percent of those living below the poverty level still receive no aid at all -- they simply fall through the many holes in the so-called "safety net."

In fact, there has been a 41 percent increase in the number of poor people since 1979.

It is against this backdrop that we view the administration's FY 1987 budget, Mr. Chairman; and, it is not a pretty picture.

Overall, the administration proposed, in general, that:

- Domestic programs would be reduced by $9 billion in FY87 and projected to be reduced by $23 billion by FY91.
- Fully one half of the $38 billion sought in deficit reductions would come from cuts in education, health, social services, agriculture, income support and retirement programs.

* $10,609 household income is the official poverty level for a family of four.

- The budget contains reductions in FY87 in at least 30 programs that serve low-income people.

More specifically, the administration proposes

- a 12 percent reduction would occur in employment and training programs, including a reduction of $279 million in the Summer Youth Jobs program.

Twenty-seven percent of those enrolled in federal employment and training programs are black Americans. Sixty percent of the Job Corp trainees are black. The Jobs Corp program alone would be cut by 44 percent below the FY86 funding level of $613 million. These cuts are proposed by the president in spite of Labor Department and other studies showing that the Job Corp is the most successful program for improving employment possibilities for low-income unemployed youth. Mr. Chairman, we can not afford these sizeable reductions in federal employment and training programs when forty percent of black youths are unemployed or when only one out of every six black youths have a job.

The Work Incentive Program, designed to help people lift themselves out of poverty, would have its FY86, program cut by the president. The president would cancel $46 million already appropriated for FY86

under his view that the Work Incentive Program is no longer needed; yet, 2 million people are being served currently by this program.

- The administration proposes a 15 percent reduction in education programs.

Twenty percent of the students benefiting from the Guaranteed Student Loan Program are minorities. This program accounts for 62 percent of the federal student financial aid; yet the president proposes reduction of special allowances and the elimination of the in-school interest subsidy. Under these changes, banks arguably could abandon the program altogether.

Approximately 25 percent of Pell Grant recipients, low-income students, or over 800,000 are minorities. The reduction of funding for Pell Grants of $154 million as a result of Gramm-Rudman further reduces available funds for loans to low-income students in view of the current $215 million funding shortfall. Furthermore, restrictions proposed for Pell Grant eligibility are projected to result in ineligibility for over 816,000 students.

These proposals are harmful particularly for minorities since they already account for less than 17 percent of the total undergraduate enrollment, as we found in our 1985 Emergency Summit.

- The administration proposes a one-third reduction in housing programs, including a $4.4 billion cancellation of FY86 funding for low-income housing.

HUD activities would be cut to $5.54 billion in FY87, compared with the FY86 funding level of $17 billion. Several programs would be eliminated including:

- public housing construction,
- rental housing for the elderly and handicapped,
- rental housing development grants,
- rental rehabilitation grants and rehabilitation loans,
- the Urban Development Grant (UDAG) program, and
- cancellation of one half of the FY86 funds appropriated for HUD subsidized housing.

The N.A.A.C.P. rejects these cuts in housing for a number of reasons.

-- Forty-five percent of those served by subsidized housing programs are black.

-- There is already a lack of decent, affordable housing within the means of most Americans.

-- A substantial number of minority families live in substandard housing yet pay an inordinate amount of their income for housing payments.

-- Federal programs providing housing subsidies have been drastically cut over the last four years and under this budget are threatened with virtual termination.

- The president calls for a 30 percent reduction in funding for Community Development Block Grants.

Funding for CDBG would drop 16 percent from the current level. This would affect city funding for Meals on Wheels, day care centers, drug abuse prevention and education program; crime prevention programs, shelters

shelters for the homeless, and other social services funded by cities.

- The Medicaid program is proposed to be cut by $18 million over the next five years.

Thirty percent of all low-income persons now served by Medicaid are black. It is not foreseen that states will cover these reductions, rather it is projected that major changes will be made in the scope of the program's coverage. This can only effect black Americans adversely.

The administration also proposes in the FY87 budget to:

- Reduce funding for Medicare and to require more payments by the elderly.
- Eliminate the Legal Services Corporation,
- Terminate funding for Title IV of the Civil Rights Act of 1964 (funds used to provide financing for the technical assistance given to schools and government units implementing public school desegregation plans.)

While drastic cuts are proposed in domestic programs of benefit to poor, low- and moderate-income people, the president proposes, on the other hand, to increase defense spending. Mr. Chairman, you know that FY87 defense outlays are estimated at $297 billion.

- Defense spending would be increased by eight percent, including a 75 percent increase in the "Star Wars" system.

Although there is projected to be an increase in the military budget, the administration has been elimina-

ting or cutting back on the agencies or departments authorized to ensure equality of treatment and of opportunity in the Armed Services.

My purpose today is not merely to recount for you the reductions in domestic programs embodied in the president's budget and tell you that the N.A.A.C.P. is opposed to them. Our Executive Board has passed a resolution calling upon the Congress to reject the president's budget. Nevertheless, the message I bring you today is that to effectively reduce the deficit, I ask that you look at some of its causes and to develop solutions based upon removing deficit causes. In short, to ask that you engage in basic problem solving, if you will.

It is apparent that the economic policies of the past five years have substantially contributed to today's budget deficit. The nation was promised that tax cuts plus increased defense spending and the elimination of "fraud, waste and abuse" in domestic spending would lead to <u>additional</u> revenues to the federal treasury and a resulting reduction in the deficit.

In fact, now we know that the converse is true. Instead the numbers add up to a cumulative deficit over the past five years equal to the combined deficits of all prior administrations. The Congressional Budget Office has estimated that the 1981 tax cut has resulted in less revenues for FY86 by $208 billion; these

revenue "losses" nearly equal the $220.5 billion projected deficit.

The N.A.A.C.P. strongly urges you to not only reject the president's budget but to develop an alternative that addresses real causes of the deficit.

Revenues losses are increased substantially by favorable tax treatments given to corporations and wealthy individuals. Now, Congress is re-examining some of those credits and deductions which were extended in the 1981 tax act. Corporations and high-income individuals received windfall tax reductions in the 1981 act; whereas, after-tax income fell for low-income individuals as a result of that act. The investment incentives that were to result from the tax package have not been realized and not significantly impacted black communities.

Defense spending includes undue waste in procurement -- this has been acknowledged by Defense Department officials. Considering this, we do believe that doubling the defense budget since 1981 is not justified and that there is room for significant spending restraints in this area.

It is clear that what has occured in the past five years is not a reduction in federal spending, but a redistribution of spending accompanied by a massive reduction in federal tax revenues.

Yet, the administration continues to blame domestic spending for the deficit; if not blamed, domestic

spending bears the entire burden of cuts to reduce the deficit. It is time for Congress to reject that notion.

Mr. Chairman, our nation cannot afford to continue these failed policies. We must provide for our poor, elderly, disabled, sick, unemployed and our youth. And we must view education as an investment in our nation. To do otherwise would make us morally and humanely bankrupt.

I thank you Mr. Chairman for receiving this testimony.

The CHAIRMAN. Thank you, Mr. Hooks.

When you look at the economic pulse of the minority community, which you have worked in for some time, and you hear in the State of the Union Message that America is back, and that American families are living in unprecedented economic prosperity, can you tell this committee, if that is true for minority families in this Nation, and if not, why not? Do you think that is the case?

Mr. HOOKS. I think it is not true. I would hope that before Mr. Reagan makes his next State of the Union Message, that he takes the time to read "The State of Black America," prepared by the Urban League, and perhaps he will get another view of facts and figures that will better help him to prepare his report to the American people.

The reason that is not true is because unemployment is still unacceptably high in the black community, particularly in the youth community. The median black income is 60 percent of the white family, and if there has been an economic recovery, it has passed a great many black Americans by, and there are specific things that could be addressed by the President, so specific programs that we think could help.

A great deal of attention has been paid to the so-called bootstrap philosophy. It ought to be obvious to everyone that if blacks had not lifted themselves by their bootstraps from 1963 on, we would still be in a situation as bad as slavery.

So, there has to be a combination of correctly administered governmental assistance as well as self-help programs in the black community, to lift us to the mainstream of this recovery that we talk about.

The CHAIRMAN. Your organization has been in the forefront of dealing with equality before the law, of dealing with the issues of getting rid of legal barriers, and also of opening up new opportuni-

ties for those who have been excluded because of their race, creed, or color. Do you believe that the Fair Housing Initiatives Program proposed by Secretary Pierce in HUD's 1987 budget is a serious proposal to deal with the problem of housing discrimination in this country?

Mr. HOOKS. Well, let me qualify it. In this administration, any proposal to do anything to aid housing is better than none, but if it were in another administration, I would not consider it to be such a great initiative.

I am trying to simply say that a little bit in this administration is more than we have been led to expect by the assault of this administration on all of the matters that involve equality before the law, the attempt of this administration to roll back consent decrees in 51 localities and jurisdictions, the attempt to undermine Executive Order 11246 or to change it are indicative that even though I don't consider that proposal of Secretary Pierce to be as good as it could have been, or should be, I must say I welcome even a faint glimmer of hope from this administration.

The CHAIRMAN. As you know, there has been a major policy debate within the administration with regard to equal opportunity for all of our Nation's citizens. There has been a great deal of discussion, both privately and publicly about Executive Order 11246.

I would like to get your impression as to whether that order is still needed today. If it is or is not needed in your view, what do you think will be the impact if the administration decides to abandon Executive Order 11246, realizing this is an order that has the Labor Department setting timetables and goals for requiring private employers to increase minority participation in the workforce?

Mr. HOOKS. I think that that order is needed very definitely. And the NAACP, along with other organizations, has conferred with Secretary of Labor Brock and other members of the administration in an attempt to prevent that order from being dismantled or exchanged.

It has not worked perfectly, but it has been the vehicle that has allowed many minority people, native Americans, Hispanic Americans, aged Americans, women and blacks to make some progress that otherwise they would not have made, and it is ironic that the Justice Department is leading the charge against this, because in years past, under other administrations, the Justice Department has been the repository of much of the hope of the black people of America, and today, it is the very opposite.

It was illuminating to note that when Mr. Reagan was asked this question about Executive Order 11246 in his press conference recently, that he showed a fundamental misunderstanding. He said he was opposed to quotas.

When the reporter pointed out to him that that order on its face said there must not be quotas, he was then forced to fall back upon the fact, well, maybe it did say that, but the bureaucrats who administer it might impose quotas as an easy way out.

So, it seems that the administration is making a determined effort to find reasons, if they do not exist, to undermine any of the initiatives which have enabled the minorities of this Nation to move forward.

The impact, I think, would be severe. We are supporting Congressman Hawkins. He has sent a letter requesting the President to not change 11246, and I have been informed that almost half the Members of the House have signed that letter, and our next line of defense would obviously be to come to the Congress and seek to get legislation under the present status.

That may be difficult, but it would present the only natural alternative, because absent this order, then the very basis upon which we have built our progress in employment would be somewhat destroyed and battered.

The only hopeful note is that we have survived so many cruel blows that maybe we will find a way to survive this, but offhand, at this time, we are concentrating all our effort, energy, and attention on trying to see to it that the administration does not roll it back, and that is an uphill fight, because it appears that in spite of advice from what we understand comes from the majority of the Cabinet, the President is still looking at this with a view toward changing it.

The CHAIRMAN. You have mentioned that the President showed a fundamental lack of understanding of Executive Order 11246 in his press conference. Have you been able to come up with some conclusions as to why this misunderstanding exists, particularly when his chief enforcement officer of the Civil Rights Division has publicly stated that since he has been in office, no one has brought before him a case involving quotas? Do you have any idea why this misunderstanding exists?

Mr. HOOKS. I can only surmise that Attorney General Meese and Mr. Reynolds, the Assistant Attorney General in charge of civil rights, have given him misinformation.

I can understand that no President can be fully aware or cognizant of all the laws one by one, and in detail, and that is why they rely upon advisors, and it is shameful if those advisors give deliberate misinformation, and I can only surmise by having read the transcript of the press conference and having seen it replayed on television, that the President has been badly misinformed by the advisors, and that he will continue to be misinformed by them on that subject.

The CHAIRMAN. Does your organization have a position on the issue of quotas as defined by the President?

Mr. HOOKS. Yes; that was ironic also, as I looked at him, when he talked about all of a sudden, he knows a lot about quotas. At one time, he was quoted that he wasn't aware of racial prejudice when he was a young person.

Now he says that he is aware that quotas were used to enforce racial discrimination. The late Clarence Mitchell was our Washington bureau representative. He made it clear that the NAACP has been opposed historically to the concept of quotas, because we knew that a quota was a ceiling above which one could not rise.

We would admit two blacks or two women or three Jewish people, but absolutely no more. From that viewpoint, quotas have a bad history, and were used to exclude rather than to include, so that many years ago, we took a position against quotas.

We believe in goals and timetables which are not artificial ceilings above which one cannot rise, but floors which must be

reached. We have explained that. I listened to the President in the press conference talking about quotas being used to exclude, and I agree with him, and also agree that 11246 does not establish quotas; far from it.

The CHAIRMAN. Have you and other leaders from the civil rights area, such as yourself, had an opportunity in the last 4 or 5 years to sit down and discuss indepth these issues with the administration, with the President or with the Attorney General?

Mr. HOOKS. No; I have not sought a meeting with the Attorney General, and after Mr. Reynolds made it clear that he felt that black leaders came to his office with one proposition and left telling something else, I personally decided not to seek meetings with him.

We did try in the Black Leadership Forum, an umbrella organization of 15 or 20 black groups that I happened to chair for 2 or 3 years, we did seek meetings with Mr. Reagan.

We got one rather lengthy meeting before he was inaugurated after his election the first term. I believe that was in December 1980, before he was sworn in in January 1981.

Since that time, the NAACP has not held any meetings with Mr. Reagan. For 2 or 3 years, we attempted that, but I don't believe we have tried in the last year, because it appears that his agenda is fixed, and I would have to have some indication that the meeting would bear some results.

We will survive in spite of Mr. Reagan, in my judgment, being opposed to most of the things that the civil rights community is in favor of, and since we have survived 5 years of it, we will have to look at what we can do for the next 3 years.

But the direct answer to your question is that as far as I know, the civil rights leadership as we know it, the major civil rights organizations have not had an indepth meeting with Mr. Reagan or his Cabinet in the last several years, although we have had meetings with Mr. Brock and very good meetings, on 11246, and some meetings with Mr. Pierce on some issues that were very good meetings.

I think I have had good conversations with Jim Baker, but basically not with that part of the administration that was moving the administration backward.

The CHAIRMAN. One final question before you have to leave. With the deficits that we have, there are going to have to be cuts made in all areas of the budget. You have said that your organization is for deficit reduction, and for reaching a balanced budget. Do you have suggestions that you would like to give this committee on a way to do that different from the budget that the President has submitted to the country—do you have any particular suggestions or if not a specific plan, things that you think ought not to be touched and thus, other things that ought to be up on the table?

Mr. HOOKS. Yes, two, one of which is very unpopular. We suggested in our 1981 alternative budget that taxes need not be decreased in the magnitude Mr. Reagan decreased them, and certainly not tilted toward the spectrum of the economy that he tilted those tax reductions to.

I have been given to understand that Mr. Mondale lost 5 million votes by advocating a tax increase, but I think we need to look at

the fact that we are mortgaging the future for today. If we are to be fair with our children and their children, we have to bear some expense now. I think there is room for tax increases in many places, in corporate income tax and in other places through elimination of certain kinds of loopholes in the Tax Code that would increase the revenue.

Second, I think that we must insist that if there is to be a reduction, that programs should share in the domestic—they should not share unequally with the defense.

There should not be a real growth of 8 percent in the defense budget while a real decline of 9 or 10 percent. The defense budget is huge, and the NAACP is not opposed to national defense, but if we take the 8 percent real increase in the defense budget, and spread it over other domestic programs, I think we would find that the increase for domestic programs would be very small.

So, for equality and justice, it seems to me that if the Congress rejects the tax increase—when I say tax increase, I am speaking in terms of elimination of certain kinds of obviously foolish loopholes, where rich individuals pay no tax, and the Secretary's suggestion is that specifically that the defense budget share equally in the cuts, and if there is to be no real growth in any domestic programs, then there should be no real growth in the defense budget.

I think that there is an 8-percent real growth in the fiscal year 1987 budget, and that is an enormous amount of money that could go a long way toward taking care of the cuts proposed.

Finally, as it relates to cuts within the domestic program, whether it should be legal services or community block grants, at this point we are not prepared to make a definitive statement on that until the first two alternatives have been explored, because we think they will eliminate the need for fighting for the crumbs that fall from the table that left over from defense spending.

The CHAIRMAN. Thank you very much, Dr. Hooks, for your testimony and statement for the record. The committee may submit to you further questions for the record. Thank you very much.

At this time, the Chair calls to the witness table John Jacob, the president of the National Urban League of America.

Mr. Jacob, we want to welcome you as a representative and head of one of our Nation's most distinguished organizations of social service and concern for the working poor people in this country. We appreciate the time that you have taken to come and testify.

As I said to Dr. Hooks, your testimony in its entirety will be submitted for the record. If you would like to summarize, feel free to do so.

STATEMENT OF JOHN E. JACOB, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL URBAN LEAGUE, INC.

Mr. JACOB. Thank you, Mr. Chairman.

Mr. Chairman, my name is John E. Jacob, and I am president and chief executive officer of the National Urban League.

As an organization firmly committed to securing equal opportunities in all sectors of society for blacks, women, and other minorities, we appreciate the opportunity to present our views regarding the 1987 budget presented by the administration.

In recent years, the administration has proposed budgets that significantly reordered the spending priorities of our Government. While the Congress has often made changes in those budgets, the administration's priorities have prevailed.

As a result, there has been a massive shift away from investments in human resources. Along with higher military spending and interest on the national debt, the refusal to increase revenues has resulted in large deficits.

Domestic spending has been cut by some 15 percent since 1981 after adjusting for inflation, even as increased needs were generated by changes in the national economy and by the larger numbers of people in poverty.

The administration's proposed 1987 budget would cut yet another 14 percent out of domestic programs. In short, programs that were inadequate in 1981 were cut heavily since then, and would be subjected to major cuts in fiscal year 1987.

This budget then, constitutes a war on the survivors.

Having wounded vitally important programs, the administration now proposes that Congress walk through the ruins and shoot the survivors.

This budget would have you put bullets through the heads of welfare, nutrition, urban, job and health programs that poor people rely upon for basic survival and for new opportunities.

At the same time, the budget refuses to increase revenues to fund human needs, it would increase military expenditures by almost $30 billion, or 11.7 percent over fiscal year 1986. And it foresees a rise of $113.6 billion for the military in 1991, a rise of 45 percent over this year.

I do not wish my remarks to be interpreted as indicating that I am not sufficiently aware of the need for strong defenses in a dangerous and uncertain world.

But at the same time the record clearly shows that the military buildup has been hasty and ill-conceived; that billions have been squandered on questionable new weapons systems, and that military readiness has been sacrificed to controversial strategic weaponry.

The overemphasis on complex new weapons system has had an effect on national social needs in an austere fiscal climate.

In effect, funding for Star Wars means less funding for poverty wars. In fiscal year 1987, the administration wants to spend $4.8 billion on the strategic defense initiative and almost $32 billion for 15 other major weapons systems, each costing over $1 billion. Even small cuts in those programs could save crucial domestic programs from extinction.

Mr. Chairman, before I outline some of the specific cuts we are most concerned about, I believe we must talk of the context in which those proposed cuts exist.

The National Urban League recently issued its State of Black America report, outlining the situation in which America's black citizens find themselves.

We have found that the economic boom has largely bypassed black Americans, a third of whom are in poverty and half of whom face severe economic hardship. Half of all black children are growing up poor. The typical black family earns far less than the Gov-

ernment itself says is needed for a minimum but decent standard of living. Black unemployment rates are in the 14- to 15-percent range, more than double those for whites.

While black Americans have suffered disproportionately, I should stress that many of their economic problems are shared with other minorities and indeed with white citizens.

More whites than blacks are on welfare, get food stamps, and are homeless. Our Nation's social needs cut across racial lines, but our Nation's response to those social needs, especially as reflected in this budget, would only make them worse.

This committee cannot perform its duties without bearing in mind the plight of the 1.5 million people who became poor since 1981. It must consider the effect of its decisions on the 9 million adults who are poor, even though they work. It must consider the needs of the more than 2 million full-time workers who earned less than the poverty line last year.

It must bear in mind the report of the Physicians Task Force on Hunger, which found that hunger is a serious national problem largely because food stamps do not reach all who are eligible for them. Their survey of 150 counties found only one-third of eligible people received food stamps.

This committee must bear in mind the recent report of the U.S. Conference of Mayors that found sharp increases in urban poverty, hunger, and homelessness last year.

And it must further bear in mind that the actions of the administration and the Congress over the past 5 years have essentially rolled back all of the economic gains made by the poorest 40 percent of the population in the preceding two decades.

That, Mr. Chairman, is the context in which this budget is presented. Given that context, one would expect either an adjustment in the Nation's misguided priorities, or at the very least a standstill in the ill-advised attempt to widen the racial and economic gaps that divide our society.

Instead, this budget offers a blueprint for the destruction of the hopes and dreams of many millions of Americans. Worse, its inevitable consequences will severely damage our Nation's social and economic future.

At this point, I would like to briefly outline just some of the elements of this budget of greatest concern to our constituents.

I first should mention some of the programs this budget proposes to end—not to cut, but to end.

Community Services Block Grants; saving $300 million at the cost of helping localities provide social services.

Legal Services, which has proved successful in allowing poor people access to the judicial system. Savings would be only $266 million, but the damage to faith in the fairness of our legal system would be incalculable.

Urban Development Action Grants, Mass Transit, and Economic Development Programs, all of which impact disproportionately on cities that house higher percentages of poor people and black people.

The Work Incentive Program, which actually does what the administration says it wants to do; help people move from welfare to work.

Mr. Chairman, it is important that programs ensuring equal access to the legal system and to economic opportunies be kept in place and funded at levels commensurate with the needs.

Those programs were called into being because they were desperately needed by poor people and by the cities in which they live and those needs did not melt away simply because an anti-Government philosophy now prevails in the executive branch.

The same point applies to the even more extensive programs the administration wishes to cripple by deep slashes in their budgets.

The single most serious problem facing the black community is employment. Black people are in an economic depression, and its effects are directly responsible for the weakened situation in which many black families find themselves.

There is a direct correlation between the availability of jobs for young black men and the existence of female-headed families.

Twenty-five years ago, three out of four black men were working and three out of four black families were intact. Today, a little over half of all black men are working full time and a little more than half of all black families are intact.

But job creation and job training programs have been destroyed or cut heavily and this proposed budget continues the national neglect of economic opportunites for the poor.

It would slash the Job Corps almost in half so that it would serve only 22,000 young people instead of the 40,000 training slots currently available. Given the proven success of the Job Corps, it would be more fitting to expand it to serve more of our jobless young people.

With black youth unemployment officially at over 40 percent and up to 70 percent in some urban neighborhoods, the budget cuts summer youth employment programs by more than one-third, condemning thousands of disadvantaged youngsters to spend the summer in idleness.

Nowhere in this budget do we find any recognition of the employment and training needs of poor Americans, displaced workers, or low-skill workers who need training to hold the jobs our economy needs to fill.

Our future economy is being held hostage to demographic forces that demand Government intervention. Declining birth rates mean fewer entrants into the labor market in coming years, and one-third of our new workers will be blacks and other minorities.

Without ensuring adequate education, skills training, and job programs that bring this altered labor force into the economic mainstream, we will face a serious labor shortage in occupations necessary to keep our industries competitive, while at the same time creating an army of alienated young people frozen out of the economy.

The National Urban League has addressed this crucial problem through cooperative training programs with business, and this year we will launch a major initiative in the field of education to ensure that the public school system meets the educational needs of black youngsters.

Less than 10 years ago blacks reached virtual parity with whites in access to college—about half of both black and white college graduates went on to further studies. But by 1982, while 52 percent

of white high school graduates went on to college, only about 36 percent of black high school graduates did.

And this terrible erosion of black educational attainment is understated because it only covers college entrance, which requires a high school diploma. The black high school dropout rate is alarming. A recent survey of Urban League affiliates placed the dropout problem at or near the top of the list of educational concerns in each of our 113 affiliates.

Given that situation, an adequate budget would provide sufficient funds to enable the Nation's public schools to meet their responsibilities to disadvantaged young people and to enable college students to remain in school.

But this budget would cut Federal student aid by one-fourth and vocational education by half. The decline in black college attendance is directly related to the erosion of Federal grants and loans over the past several years.

Further cuts will lead to a steep decline in black college attendance, since the vast majority of black youth are in families whose earnings are far below what is necessary to pay today's inflated college costs.

Cutting some $3.2 billion out of total Federal education outlays at a time of an international economic race for technological supremacy amounts to disinvestment in America's future.

Mr. Chairman, if this budget were framed in Moscow or Tokyo with the aim of weakening America's economy and its ability to compete, it could hardly be more effective.

When it comes to dealing with the social welfare, housing and health needs of the American people, this budget is even more of a failure.

At a time when the numbers of poor people are at a record high for a nonrecession year, the budget proposes cutting over $600 million from AFDC.

I must remind this committee that welfare has already been drastically cut because inflation has cut the purchasing power of the typical welfare check by one-third in the past decade. AFDC payments, even in the most generous States, fall far below the poverty line and it is estimated that only about half of poor people receive assistance.

With hunger again becoming a serious national problem, the budget proposes cutting food stamps by $300 million, mainly through tightening eligibility rules that already exclude many people who need food assistance.

At a time when there is national concern over child health and when some cities, including Washington, DC, report levels of black infant mortality rates more appropriate to the Third World, the budget would cut almost $700 million out of child nutrition programs.

I should add that in the face of cuts concentrated on programs that feed and educate young people in poor families, I endorse the remarks made by the columnist George Will, who said: "It is cheaper to feed the child than jail the man. Persons who do not understand this are not conservatives, just dim."

At a time when homelessness is becoming a national disgrace and a growing burden on many large cities, the budget would cut $700 million out of Federal housing programs.

Mr. Chairman, a Federal budget should be framed by first determining what the Nation's needs are and then raising the revenues required to cover them. This budget was framed without regard to either the short-range survival needs of significant numbers of citizens nor of the long-term educational and economic needs of the Nation.

It represents a refusal to invest in the American people—refusal to make the investments in human resources that will yield huge dividends in the form of an educated, skilled, healthy citizenry capable of taking America to a new plateau of achievement.

The refusal to present Congress with a realistic budget or to raise sufficient revenues to support necessary Federal activities is an abdication of responsibility that leaves a vacuum Congress must fill.

I am fully aware that your task is made harder by the Gramm-Rudman legislation that limits Congress' freedom of movement, but Gramm-Rudman does not mandate taking school lunches away from children. It doesn't make tax increases impossible, and it doesn't require shifting spending from ground troops to research labs.

I urge this committee not to allow Gramm-Rudman or the Office of Management and Budget or even the President's veto threats to stand in the way of framing a budget that meets national needs.

I urge you not to impose further sacrifices on an already burdened poverty population. Poor people have paid for this economic boom and for tax breaks for the affluent with unemployment, reduced survival programs, and shattered hopes.

They have not shared in the benefits of recent policies while they have assumed all of the burdens of the negatives of those policies.

I urge you to prevent further injustices by rewriting this budget in a way that places the needs of the poor at the top of your priority list.

When this budget was first announced, someone said that as far as Congress is concerned, it is "dead on arrival." Well, it has arrived and it is not dead. I urge you to kill it and spare the Nation's poor people further misery.

Thank you, Mr. Chairman.

[Testimony resumes on p. 565.]

[The prepared statement of Mr. Jacob follows:]

PREPARED STATEMENT OF JOHN E. JACOB

MR. CHAIRMAN, MEMBERS OF THIS DISTINGUISHED COMMITTEE: MY NAME IS JOHN E. JACOB, AND I AM PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE NATIONAL URBAN LEAGUE.

THE NATIONAL URBAN LEAGUE (NUL) IS A NON-PROFIT COMMUNITY SERVICE ORGANIZATION DEDICATED TO SEEKING ACHIEVEMENT OF PARITY FOR BLACKS AND OTHER MINORITIES IN EVERY PHASE OF AMERICAN LIFE. THROUGH ITS 113 AFFILIATES LOCATED IN 34 STATES, THE LEAGUE SERVES MORE THAN A MILLION INDIVIDUALS EACH YEAR.

AS AN ORGANIZATION FIRMLY COMMITTED TO SECURING EQUAL OPPORTUNITIES IN ALL SECTORS OF SOCIETY FOR BLACKS, WOMEN, AND OTHER MINORITIES, WE APPRECIATE THE OPPORTUNITY TO PRESENT OUR VIEWS REGARDING THE 1987 BUDGET PRESENTED BY THE ADMINISTRATION.

IN RECENT YEARS, THE ADMINISTRATION HAS PROPOSED BUDGETS THAT SIGNIFICANTLY REORDERED THE SPENDING PRIORITIES OF OUR GOVERNMENT. WHILE THE CONGRESS HAS OFTEN MADE CHANGES IN THOSE BUDGETS, THE ADMINISTRATION'S PRIORITIES HAVE PREVAILED.

AS A RESULT THERE HAS BEEN A MASSIVE SHIFT AWAY FROM INVESTMENTS IN HUMAN RESOURCES. ALONG WITH HIGHER MILITARY SPENDING AND INTEREST ON THE NATIONAL DEBT, THE REFUSAL TO INCREASE REVENUES HAS RESULTED IN LARGE DEFICITS.

DOMESTIC SPENDING HAS BEEN CUT BY SOME FIFTEEN PERCENT SINCE 1981 AFTER ADJUSTING FOR INFLATION, EVEN AS INCREASED NEEDS WERE GENERATED BY CHANGES IN THE NATIONAL ECONOMY AND BY THE LARGER NUMBERS OF PEOPLE IN POVERTY.

THE ADMINISTRATION'S PROPOSED 1987 BUDGET WOULD CUT YET ANOTHER 14 PERCENT OUT OF DOMESTIC PROGRAMS. IN SHORT, PROGRAMS THAT WERE INADEQUATE IN 1981 WERE CUT HEAVILY SINCE THEN, AND WOULD BE SUBJECTED TO MAJOR CUTS IN FISCAL '87.

THIS BUDGET THEN, CONSTITUTES A WAR ON THE SURVIVORS.

HAVING WOUNDED VITALLY IMPORTANT PROGRAMS, THE ADMINISTRATION NOW PROPOSES THAT CONGRESS WALK THROUGH THE RUINS AND SHOOT THE SURVIVORS.

THIS BUDGET WOULD HAVE YOU PUT BULLETS THROUGH THE HEADS OF WELFARE, NUTRITION, URBAN, JOB AND HEALTH PROGRAMS THAT POOR PEOPLE RELY UPON FOR BASIC SURVIVAL AND FOR NEW OPPORTUNITIES.

AT THE SAME TIME, THE BUDGET REFUSES TO INCREASE REVENUES TO FUND HUMAN NEEDS. IT WOULD INCREASE MILITARY EXPENDITURES BY ALMOST $30 BILLION, OR 11.7 PERCENT OVER FISCAL 1986. AND IT FORESEES A RISE OF $113.6 BILLION FOR THE MILITARY IN 1991, A RISE OF 45 PERCENT OVER THIS YEAR.

I DO NOT WISH MY REMARKS TO BE INTERPRETED AS INDICATING THAT I AM NOT SUFFICIENTLY AWARE OF THE NEED FOR STRONG DEFENSES IN A DANGEROUS AND UNCERTAIN WORLD.

BUT AT THE SAME TIME THE RECORD CLEARLY SHOWS THAT THE MILITARY BUILDUP HAS BEEN HASTY AND ILL-CONCEIVED; THAT BILLIONS HAVE BEEN SQUANDERED ON QUESTIONABLE NEW WEAPONS SYSTEMS, AND THAT MILITARY READINESS HAS BEEN SACRIFICED TO CONTROVERSIAL STRATEGIC WEAPONRY.

THE OVER-EMPHASIS ON COMPLEX NEW WEAPONS SYSTEM HAS HAD AN EFFECT ON NATIONAL SOCIAL NEEDS IN AN AUSTERE FISCAL CLIMATE.

IN EFFECT, FUNDING FOR STAR WARS MEANS LESS FUNDING FOR POVERTY WARS. IN FISCAL 1987, THE ADMINISTRATION WANTS TO SPEND $4.8 BILLION ON THE STRATEGIC DEFENSE INITIATIVE AND ALMOST $32 BILLION FOR 15 OTHER MAJOR WEAPONS SYSTEMS, EACH COSTING OVER $1 BILLION. EVEN SMALL CUTS IN THOSE PROGRAMS COULD SAVE CRUCIAL DOMESTIC PROGRAMS FROM EXTINCTION.

MR. CHAIRMAN, BEFORE I OUTLINE SOME OF THE SPECIFIC CUTS WE ARE MOST CONCERNED ABOUT I BELIEVE WE MUST TALK OF THE CONTEXT IN WHICH THOSE PROPOSED CUTS EXIST.

THE NATIONAL URBAN LEAGUE RECENTLY ISSUED ITS STATE OF BLACK AMERICA REPORT, OUTLINING THE SITUATION IN WHICH AMERICA'S BLACK CITIZENS FIND THEMSELVES.

WE HAVE FOUND THAT THE ECONOMIC BOOM HAS LARGELY BYPASSED BLACK AMERICANS, A THIRD OF WHOM ARE IN POVERTY AND HALF OF WHOM FACE SEVERE ECONOMIC HARDSHIP. HALF OF ALL BLACK CHILDREN ARE GROWING UP POOR. THE TYPICAL BLACK FAMILY EARNS FAR LESS THAN THE GOVERNMENT ITSELF SAYS IS NEEDED FOR A MINIMUM BUT DECENT STANDARD OF LIVING. BLACK UNEMPLOYMENT RATES ARE IN THE 14-15 PERCENT RANGE, MORE THAN DOUBLE THOSE FOR WHITES.

WHILE BLACK AMERICANS HAVE SUFFERED DISPROPORTIONATELY, I SHOULD STRESS THAT MANY OF THEIR ECONOMIC PROBLEMS ARE SHARED WITH OTHER MINORITIES AND WITH WHITE CITIZENS.

MORE WHITES THAN BLACKS ARE ON WELFARE, GET FOOD STAMPS, AND ARE HOMELESS. OUR NATION'S SOCIAL NEEDS CUT ACROSS RACIAL LINES. BUT OUR NATION'S RESPONSE TO THOSE SOCIAL NEEDS, ESPECIALLY AS REFLECTED IN THIS BUDGET, WOULD ONLY MAKE THEM WORSE.

THIS COMMITTEE CANNOT PERFORM ITS DUTIES WITHOUT BEARING IN MIND THE PLIGHT OF THE 1.5 MILLION PEOPLE WHO BECAME POOR SINCE 1981. IT MUST CONSIDER THE EFFECT OF ITS DECISIONS ON THE 9 MILLION ADULTS WHO ARE POOR, EVEN THOUGH THEY WORK. IT MUST CONSIDER THE NEEDS OF THE MORE THAN TWO MILLION FULL-TIME WORKERS WHO EARNED LESS THAN THE POVERTY LINE LAST YEAR.

IT MUST BEAR IN MIND THE REPORT OF THE PHYSICIANS TASK FORCE ON HUNGER, WHICH FOUND THAT HUNGER IS A SERIOUS NATIONAL PROBLEM LARGELY BECAUSE FOOD STAMPS DO NOT REACH ALL WHO ARE ELIGIBLE FOR THEM. THEIR SURVEY OF 150 COUNTIES FOUND ONLY A THIRD OF ELIGIBLE PEOPLE RECEIVED FOOD STAMPS.

THIS COMMITTEE MUST BEAR IN MIND THE RECENT REPORT OF THE U.S. CONFERENCE OF MAYORS THAT FOUND SHARP INCREASES IN URBAN POVERTY, HUNGER AND HOMELESSNESS LAST YEAR.

AND IT MUST FURTHER BEAR IN MIND THAT THE ACTIONS OF THE ADMINISTRATION AND THE CONGRESS OVER THE PAST FIVE YEARS HAVE ESSENTIALLY ROLLED BACK ALL OF THE ECONOMIC GAINS MADE BY THE POOREST FORTY PERCENT OF THE POPULATION IN THE PRECEDING TWO DECADES.

THAT, MR. CHAIRMAN, IS THE CONTEXT IN WHICH THIS BUDGET IS PRESENTED. GIVEN THAT CONTEXT, ONE WOULD EXPECT EITHER AN ADJUSTMENT IN THE NATION'S MISGUIDED PRIORITIES, OR AT THE VERY LEAST A STANDSTILL IN THE ILL-ADVISED ATTEMPT TO WIDEN THE RACIAL AND ECONOMIC GAPS THAT DIVIDE OUR SOCIETY.

INSTEAD, THIS BUDGET OFFERS A BLUEPRINT FOR THE DESTRUCTION OF THE HOPES AND DREAMS OF MANY MILLIONS OF AMERICANS. WORSE, ITS INEVITABLE CONSEQUENCES WILL SEVERELY DAMAGE OUR NATION'S SOCIAL AND ECONOMIC FUTURE.

AT THIS POINT, I WOULD LIKE TO BRIEFLY OUTLINE JUST SOME OF THE ELEMENTS OF THIS BUDGET OF GREATEST CONCERN TO OUR CONSTITUENTS.

I FIRST SHOULD MENTION SOME OF THE PROGRAMS THIS BUDGET PROPOSES TO END -- NOT TO CUT, BUT TO END.

: COMMUNITY SERVICES BLOCK GRANTS. SAVING $300 MILLION AT THE COST OF HELPING LOCALITIES PROVIDE SOCIAL SERVICES.

: LEGAL SERVICES, WHICH HAS PROVED SUCCESSFUL IN ALLOWING POOR PEOPLE ACCESS TO THE JUDICIAL SYSTEM. SAVINGS WOULD BE ONLY $266 MILLION, BUT THE DAMAGE TO FAITH IN THE FAIRNESS OF OUR LEGAL SYSTEM WOULD BE INCALCULABLE.

: URBAN DEVELOPMENT ACTION GRANTS, MASS TRANSIT, AND ECONOMIC DEVELOPMENT PROGRAMS -- ALL OF WHICH IMPACT DISPROPORTIONATELY ON CITIES THAT HOUSE HIGHER PERCENTAGES OF POOR PEOPLE AND BLACK PEOPLE.

: AND THE WORK INCENTIVE PROGRAM, WHICH ACTUALLY DOES WHAT THE ADMINISTRATION SAYS IT WANTS TO DO --HELP PEOPLE MOVE FROM WELFARE TO WORK.

MR. CHAIRMAN, IT IS IMPORTANT THAT PROGRAMS ENSURING EQUAL ACCESS TO THE LEGAL SYSTEM AND TO ECONOMIC OPPORTUNITIES BE KEPT IN PLACE AND FUNDED AT LEVELS COMMENSURATE WITH THE NEEDS.

THOSE PROGRAMS WERE CALLED INTO BEING BECAUSE THEY WERE DESPERATELY NEEDED BY POOR PEOPLE AND BY THE CITIES IN WHICH THEY LIVE, AND THOSE NEEDS DID NOT MELT AWAY SIMPLY BECAUSE AN ANTI-GOVERNMENT PHILOSOPHY NOW PREVAILS IN THE EXECUTIVE BRANCH.

THE SAME POINT APPLIES TO [illegible] EVEN MORE EXTENSIVE PROGRAMS THE ADMINISTRATION WISHES TO CRIPPLE BY DEEP SLASHES IN THEIR BUDGETS.

THE SINGLE MOST SERIOUS PROBLEM FACING THE BLACK COMMUNITY IS EMPLOYMENT. BLACK PEOPLE ARE IN AN ECONOMIC DEPRESSION, AND ITS EFFECTS ARE DIRECTLY RESPONSIBLE FOR THE WEAKENED SITUATION IN WHICH MANY BLACK FAMILIES FIND THEMSELVES.

THERE IS A DIRECT CORRELATION BETWEEN THE AVAILABILITY OF JOBS FOR YOUNG BLACK MEN AND THE EXISTENCE OF FEMALE-HEADED FAMILIES.

TWENTY-FIVE YEARS AGO, THREE OUT OF FOUR BLACK MEN WERE WORKING AND THREE OUT OF FOUR BLACK FAMILIES WERE INTACT. TODAY, A LITTLE OVER HALF OF ALL BLACK MEN ARE WORKING FULL-TIME, AND A LITTLE MORE THAN HALF OF ALL BLACK FAMILIES ARE INTACT.

BUT JOB CREATION AND JOB TRAINING PROGRAMS HAVE BEEN DESTROYED OR CUT HEAVILY. AND THIS PROPOSED BUDGET CONTINUES THE NATIONAL NEGLECT OF ECONOMIC OPPORTUNITIES FOR THE POOR.

IT WOULD SLASH THE JOB CORPS ALMOST IN HALF SO THAT IT WOULD SERVE ONLY 22,000 YOUNG PEOPLE INSTEAD OF THE 40,000 TRAINING SLOTS CURRENTLY AVAILABLE. GIVEN THE PROVEN SUCCESS OF THE JOB CORPS, IT WOULD BE MORE FITTING TO EXPAND IT TO SERVE MORE OF OUR JOBLESS YOUNG PEOPLE.

WITH BLACK YOUTH UNEMPLOYMENT OFFICIALLY AT OVER FORTY PERCENT AND UP TO SEVENTY PERCENT IN SOME URBAN NEIGHBORHOODS, THE BUDGET CUTS SUMMER YOUTH EMPLOYMENT PROGRAMS BY MORE THAN A THIRD, CONDEMNING THOUSANDS OF DISADVANTAGED YOUNGSTERS TO SPEND THE SUMMER IN IDLENESS.

NOWHERE IN THIS BUDGET DO WE FIND ANY RECOGNITION OF THE EMPLOYMENT AND TRAINING NEEDS OF POOR AMERICANS, DISPLACED WORKERS, OR LOW-SKILL WORKERS WHO NEED TRAINING TO HOLD THE JOBS OUR ECONOMY NEEDS TO FILL.

OUR FUTURE ECONOMY IS BEING HELD HOSTAGE TO DEMOGRAPHIC FORCES THAT DEMAND GOVERNMENT INTERVENTION. DECLINING BIRTH RATES MEAN FEWER ENTRANTS INTO THE LABOR MARKET IN COMING YEARS, AND A THIRD OF OUR NEW WORKERS WILL BE BLACKS AND OTHER MINORITIES.

WITHOUT ENSURING ADEQUATE EDUCATION, SKILLS TRAINING AND JOB PROGRAMS THAT BRING THIS ALTERED LABOR FORCE INTO THE ECONOMIC MAINSTREAM, WE WILL FACE A SERIOUS LABOR SHORTAGE IN OCCUPATIONS NECESSARY TO KEEP OUR INDUSTRIES COMPETITIVE, WHILE AT THE SAME TIME CREATING AN ARMY OF ALIENATED YOUNG PEOPLE FROZEN OUT OF THE ECONOMY.

THE NATIONAL URBAN LEAGUE HAS ADDRESSED THIS CRUCIAL PROBLEM THROUGH COOPERATIVE TRAINING PROGRAMS WITH BUSINESS, AND THIS YEAR WE WILL LAUNCH A MAJOR INITIATIVE IN THE FIELD OF EDUCATION TO ENSURE THAT THE PUBLIC SCHOOL SYSTEM MEETS THE EDUCATIONAL NEEDS OF BLACK YOUNGSTERS.

LESS THAN TEN YEARS AGO BLACKS REACHED VIRTUAL PARITY WITH WHITES IN ACCESS TO COLLEGE -- ABOUT HALF OF BOTH BLACK AND WHITE COLLEGE GRADUATES WENT ON TO FURTHER STUDIES. BUT BY 1982, WHILE 52 PERCENT OF WHITE HIGH SCHOOL GRADUATES WENT ON TO COLLEGE, ONLY ABOUT 36 PERCENT OF BLACK HIGH SCHOOL GRADUATES DID.

AND THIS TERRIBLE EROSION OF BLACK EDUCATIONAL ATTAINMENT IS UNDERSTATED BECAUSE IT ONLY COVERS COLLEGE ENTRANCE, WHICH REQUIRES A HIGH SCHOOL DIPLOMA. THE BLACK HIGH SCHOOL DROPOUT RATE IS ALARMING -- A RECENT SURVEY OF URBAN LEAGUE AFFILIATES PLACED THE DROPOUT PROBLEM AT OR NEAR THE TOP OF THE LIST OF EDUCATIONAL CONCERNS IN EACH OF OUR 113 AFFILIATES.

GIVEN THAT SITUATION, AN ADEQUATE BUDGET WOULD PROVIDE SUFFICIENT FUNDS TO ENABLE THE NATION'S PUBLIC SCHOOLS TO MEET THEIR RESPONSIBILITIES TO DISADVANTAGED YOUNG PEOPLE AND TO ENABLE COLLEGE STUDENTS TO REMAIN IN SCHOOL.

BUT THIS BUDGET WOULD CUT FEDERAL STUDENT AID BY A FOURTH AND VOCATIONAL EDUCATION BY HALF. THE DECLINE IN BLACK COLLEGE ATTENDANCE IS DIRECTLY RELATED TO THE EROSION OF FEDERAL GRANTS AND LOANS OVER THE PAST SEVERAL YEARS.

FURTHER CUTS WILL LEAD TO A STEEP DECLINE IN BLACK COLLEGE ATTENDANCE, SINCE THE VAST MAJORITY OF BLACK YOUTH ARE IN FAMILIES WHOSE EARNINGS ARE FAR BELOW WHAT IS NECESSARY TO PAY TODAY'S INFLATED COLLEGE COSTS.

CUTTING SOME $3.2 BILLION OUT OF TOTAL FEDERAL EDUCATION OUTLAYS AT A TIME OF AN INTERNATIONAL ECONOMIC RACE FOR TECHNOLOGICAL SUPREMACY AMOUNTS TO DISINVESTMENT IN AMERICA'S FUTURE.

MR. CHAIRMAN, IF THIS BUDGET WERE FRAMED IN MOSCOW OR TOKYO WITH THE AIM OF WEAKENING AMERICA'S ECONOMY AND ITS ABILITY TO COMPETE, IT COULD HARDLY BE MORE EFFECTIVE.

WHEN IT COMES TO DEALING WITH THE SOCIAL WELFARE, HOUSING AND HEALTH NEEDS OF THE AMERICAN PEOPLE, THIS BUDGET IS EVEN MORE OF A FAILURE.

AT A TIME WHEN THE NUMBERS OF POOR PEOPLE ARE AT A RECORD HIGH FOR A NON-RECESSION YEAR, THE BUDGET PROPOSES CUTTING OVER $600 MILLION FROM AFDC.

I MUST REMIND THIS COMMITTEE THAT WELFARE HAS ALREADY BEEN DRASTICALLY CUT BECAUSE INFLATION HAS CUT THE PURCHASING POWER OF THE TYPICAL WELFARE CHECK BY A THIRD IN THE PAST DECADE. AFDC PAYMENTS, EVEN IN THE MOST GENEROUS STATES, FALL FAR BELOW THE POVERTY LINE AND IT IS ESTIMATED THAT ONLY ABOUT HALF OF POOR PEOPLE RECEIVE ASSISTANCE.

WITH HUNGER AGAIN BECOMING A SERIOUS NATIONAL PROBLEM, THE BUDGET PROPOSES CUTTING FOOD STAMPS BY $300 MILLION, MAINLY THROUGH TIGHTENING ELIGIBILITY RULES THAT ALREADY EXCLUDE MANY PEOPLE WHO NEED FOOD ASSISTANCE.

AT A TIME WHEN THERE IS NATIONAL CONCERN OVER CHILD HEALTH AND WHEN SOME CITIES -- INCLUDING WASHINGTON, DC -- REPORT LEVELS OF BLACK INFANT MORTALITY RATES MORE APPROPRIATE TO THE THIRD WORLD, THE BUDGET WOULD CUT ALMOST $700 MILLION OUT OF CHILD NUTRITION PROGRAMS.

I SHOULD ADD THAT, IN THE FACE OF CUTS CONCENTRATED ON PROGRAMS THAT FEED AND EDUCATE YOUNG PEOPLE IN POOR FAMILIES I ENDORSE THE REMARKS MADE BY THE COLUMNIST GEORGE WILL, WHO SAID:

"IT IS CHEAPER TO FEED THE CHILD THAN JAIL THE MAN. PERSONS WHO DO NOT UNDERSTAND THIS ARE NOT CONSERVATIVES, JUST DIM."

AT A TIME WHEN HOMELESSNESS IS BECOMING A NATIONAL DISGRACE AND A GROWING BURDEN ON MANY LARGE CITIES, THE BUDGET WOULD CUT $700 MILLION OUT OF FEDERAL HOUSING PROGRAMS.

THE END OF HOUSING CONSTRUCTION SUBSIDIES FOR LOW-INCOME FAMILIES, THE ELDERLY, AND THE HANDICAPPED WILL FURTHER RESTRICT HOUSING AVAILABILITY FOR THOSE GROUPS. AND WHATEVER THE MERITS OF THE ADMINISTRATION'S HOUSING VOUCHER PLANS, IT IS IRRESPONSIBLE TO ADOPT SUCH A SWEEPING CHANGE IN NATIONAL HOUSING POLICIES WITHOUT ADEQUATE TESTING TO DETERMINE WHETHER THE NEW SYSTEM WILL ACTUALLY RESULT IN EXPANDED HOUSING OPPORTUNITIES.

FINALLY, AT A TIME WHEN AN AGING POPULATION AND A YOUTHFUL, LARGE DISADVANTAGED BLACK POPULATION LOOK TO MEDICARE AND MEDICAID FOR PROVISION OF DECENT HEALTH CARE, THE BUDGET WOULD SLASH THOSE PROGRAMS HEAVILY.

I AM FULLY AWARE OF THE NEED TO CONTROL HEALTH CARE COSTS, BUT I URGE THE COMMITTEE TO NOTE THAT THE BUDGET'S CUTS OF $1.3 BILLION FROM THE MEDICAID PROGRAM WILL INEVITABLY LEAD TO A DETERIORATION OF HEALTH CARE FOR POOR PEOPLE.

THE NATIONAL URBAN LEAGUE'S DEEP INVOLVEMENT IN TEENAGE PREGNANCY PREVENTION PROGRAMS HAS LED US TO OBSERVE THAT DISADVANTAGED YOUNG MOTHERS AND PREGNANT WOMEN OFTEN DO NOT GET THE HEALTH CARE THEY NEED. THE RESULT IS HIGHER BLACK INFANT MORTALITY AND DISABILITY RATES, WHICH IMPOSE DRASTIC COSTS ON BLACK FAMILIES, AND ON THE SOCIETY THAT MUST PROVIDE CARE FOR DISABLED INFANTS. TODAY'S SAVINGS COULD WELL RESULT IN FAR HIGHER COSTS IN THE FUTURE.

ALL OF THE PROGRAMS I HAVE DISCUSSED HERE -- AND I COULD HAVE MENTIONED OTHERS -- ARE INVESTMENTS IN THE HUMAN RESOURCES OF OUR NATION. THEY ARE PROGRAMS THAT FEED, HOUSE AND TRAIN THE HUNGRY AND THE DISPOSSESSED. THEY ARE PROGRAMS THAT OFFER HOPE FOR A BETTER LIFE AND A CHANCE TO MAKE IT IN OUR SOCIETY.

MANY OF THESE CUTS ARE SUGGESTED ON THE GROUNDS THAT STATES AND CITIES WILL FILL THE GAP. BUT MANY OF THE CUTS MADE OVER THE PAST FIVE YEARS WERE NOT REPLACED BY STATE AND LOCAL GOVERNMENTS OR BY VOLUNTARY INSTITUTIONS. INSTEAD, THOSE CUTS LED TO HIGHER POVERTY FIGURES AND FEWER SERVICES TO THOSE MOST IN NEED.

THIS BUDGET WOULD PUSH THAT PROCESS OVER THE BRINK. THE THEORY THAT FEDERAL BUDGET CUTS CAN BE REPLACED AT THE STATE AND LOCAL LEVEL IS A THEORY THAT IS WRONG. STATES AGAIN WILL BE ASKED TO CHOOSE BETWEEN WORTHY PROGRAMS WHILE THEMSELVES LOSING FEDERAL GRANTS.

THIS BUDGET IS IN EFFECT SAYING THAT THE FEDERAL GOVERNMENT REFUSES TO MEET ITS RESPONSIBILITIES FOR PROBLEMS THAT ARE NATIONWIDE IN SCOPE AND REQUIRE NATIONAL SOLUTIONS.

WE HAVE SEEN ENOUGH IRRESPONSIBILITY AT THE FEDERAL LEVEL. IT IS NOW TIME FOR RESPONSIBLE ACTION, AND I CALL ON THE CONGRESS TO PROTECT THE POOR FROM A BUDGET THAT REFUSES TO MEET THEIR NEEDS.

MR. CHAIRMAN, A FEDERAL BUDGET SHOULD BE FRAMED BY FIRST DETERMINING WHAT THE NATION'S NEEDS ARE AND THEN RAISING THE REVENUES REQUIRED TO COVER THEM.

THIS BUDGET WAS FRAMED WITHOUT REGARD TO EITHER THE SHORT-RANGE SURVIVAL NEEDS OF SIGNIFICANT NUMBERS OF CITIZENS NOR OF THE LONG-TERM EDUCATIONAL AND ECONOMIC NEEDS OF THE NATION.

IT REPRESENTS A REFUSAL TO INVEST IN THE AMERICAN PEOPLE -- A REFUSAL TO MAKE THE INVESTMENTS IN HUMAN RESOURCES THAT WILL YIELD HUGE DIVIDENDS IN THE FORM OF AN EDUCATED, SKILLED, HEALTHY CITIZENRY CAPABLE OF TAKING AMERICA TO A NEW PLATEAU OF ACHIEVEMENT.

THE REFUSAL TO PRESENT CONGRESS WITH A REALISTIC BUDGET OR TO RAISE SUFFICIENT REVENUES TO SUPPORT NECESSARY FEDERAL ACTIVITIES IS AN ABDICATION OF RESPONSIBILITY THAT LEAVES A VACUUM CONGRESS MUST FILL.

I AM FULLY AWARE THAT YOUR TASK IS MADE HARDER BY THE GRAMM-RUDMAN LEGISLATION THAT LIMITS CONGRESS' FREEDOM OF MOVEMENT. BUT GRAMM-RUDMAN DOES NOT MANDATE TAKING SCHOOL LUNCHES AWAY FROM CHILDREN. IT DOESN'T MAKE TAX INCREASES IMPOSSIBLE. AND IT DOESN'T REQUIRE SHIFTING SPENDING FROM GROUND TROOPS TO RESEARCH LABS.

I URGE THIS COMMITTEE NOT TO ALLOW GRAMM-RUDMAN OR THE OFFICE OF MANAGEMENT AND BUDGET OR EVEN THE PRESIDENT'S VETO THREATS TO STAND IN THE WAY OF FRAMING A BUDGET THAT MEETS NATIONAL NEEDS.

AND I URGE YOU NOT TO IMPOSE FURTHER SACRIFICES ON AN ALREADY BURDENED POVERTY POPULATION. POOR PEOPLE HAVE PAID FOR THIS ECONOMIC BOOM AND FOR TAX BREAKS FOR THE AFFLUENT WITH UNEMPLOYMENT, REDUCED SURVIVAL PROGRAMS, AND SHATTERED HOPES.

THEY HAVE NOT SHARED IN THE BENEFITS OF RECENT POLICIES WHILE THEY HAVE ASSUMED ALL OF THE BURDENS OF THE NEGATIVES OF THOSE POLICIES.

I URGE YOU TO PREVENT FURTHER INJUSTICES BY REWRITING THIS BUDGET IN A WAY THAT PLACES THE NEEDS OF THE POOR AT THE TOP OF YOUR PRIORITY LIST.

WHEN THIS BUDGET WAS FIRST ANNOUNCED SOMEONE SAID THAT AS FAR AS CONGRESS IS CONCERNED, IT IS "DEAD ON ARRIVAL." WELL, IT HAS ARRIVED AND IT IS NOT DEAD. I URGE YOU TO KILL IT AND SPARE THE NATION'S POOR PEOPLE FURTHER MISERY.

The CHAIRMAN. Thank you very much, Mr. Jacob.

I listen to your testimony today and your statistics, particularly in terms of impacts upon low-income and minority persons. I also listened to the President's State of the Union Message. Would it be accurate to say that you are saying that there is a different state of the Union for minority and poor which the President is not aware of? Although he is speaking about family and family values, are you saying that this budget does not basically support the rhetoric of family values?

Mr. JACOB. I do, indeed. First, I do believe that there are two Americas, one that is represented by the Dow Jones running off the charts, one that is represented by what could be interpreted by some economists as full employment, one that is represented by an economic boom and that is the America that the President seems to know and understand and works to service.

But there is another America that he is equally as obligated to service by the Constitution and yet he has not done so and that is the population that is represented by 15 percent unemployment, that is represented by one-third of people living in poverty, half of all black children being in poverty, by people who are suffering desperately and that suffering has been increased over the past 5 years, and that is the America that the President omitted in his State of the Union Address, ignored in his policies and his programs during the last 5 years.

One of my great fears about the surfacing of the great concern about the family as presented by the President is that it creates in my mind a great fear that the whole notion of what the family is and ought to be will be used to indict black America and indeed will be used to punish black America. For, if you began with the assumption that the reason why we have high teenage pregnancy in black America is because we provide welfare to people who have children, then the way to solve that problem is to eliminate welfare, and so what I see happening then as we build mounds and mounds of rhetoric about families, we are using that rhetoric as a rationale to eliminate programs that are needed to help strengthen families and indeed strengthen the least among us.

The CHAIRMAN. Let me ask another question. As someone who has been monitoring what is defined in the Federal Government as the "minority community," which as you well know includes women, where does your organization stand on the issue of quotas? The President keeps implying that the minority community is seeking quotas. Second, based upon your 20-year history of involvement with equal opportunity, as a result of the laws that have been passed over the last 20 years in the post-civil rights period, who has benefited the most? Who has gone through the doors of opportunity more than any other group?

Mr. JACOB. First of all, there is a great tendency in this administration to use the term interchangeably "quotas" with affirmative action with goals and timetables. It is a great distortion of the condition that we are confronted with.

I don't know of any group that has advocated the use of quotas. Personally, I am not threatened by the term because I understand what the terms means, but I don't know of any group that has advocated quotas. What groups advocate are goals and timetables to

be used as measurements to determine whether or not progress is being made.

This administration tends to ignore what goals and timetables are designed to do and has indeed fixed on the label quotas because it conjures up in the minds of the consuming public that black people are asking for something that is different from what America has provided others.

There is no question in my mind that zero is a quota. There is no question in my mind that one is a quota. There is no question that America has operated under a quota system throughout history and the quota has been to ignore black folks and exclude them from the process, so the whole notion created with affirmative action and goals and timetables was to acknowledge that there are parts of our society that have been excluded and there must be a demonstrative effort for inclusiveness.

Affirmative action works and I cannot help but believe that one of the reasons they are so exercised about affirmative action is that it works, not only by my data, but by their data. I saw the report, never released, by the Department of Labor, that showed from a study of 77,000 companies, 20 million employees, those who had Government contracts that required and mandated them to an affirmative action program utilizing goals and timetables did significantly better in hiring and promoting minorities and women than companies who did not.

The evidence is clear. The evidence is available. White people have benefited more from this system than black people. Every time there has been a training program designed, white people were included in the program.

Now keep in mind that the program would not have even existed had there not been affirmative action being designed for the inclusion of black people or minoirites or women. The mere fact that the program got created added an additional number of training opportunities and jobs for white America.

So that affirmative action goals and timetables have never been the sole province of simply minorities. Every sector of America has benefited from these programs.

The CHAIRMAN. Some have suggested that the chief beneficiary of the equal opportunity laws of the last 20 years has not been blacks or Hispanics, but maybe American women have benefited the most in terms of doorways of opportunity. Would you concur with that, or do we have any statistical evidence?

Mr. JACOB. The data would validate that. If we had maintained the same level of male labor force participation between 1972 and 1984, we would have needed to create 28 million new jobs. The economy only created 23 million jobs.

Because of the large influx of women into the marketplace, particularly white women who came in better educated, who came in better trained, they gained access to many of those jobs.

So, what we have, therefore, as a result of that is that with the large influx of women coming into the marketplace and the small amount of jobs being created, the makeup of that 5 million deficit was made up by high black and male unemployment.

Let me hasten to add, Mr. Chairman, that I believe this economy ought to have the capacity to absorb women coming into the labor

force. I believe this economy ought to have the capacity to absorb women and blacks and minorities being in the labor force.

The fact that it has decided to substitute one for the other is not an indictment against women coming into the labor force, it is an indictment against our economy not being able and ready and willing to accommodate all people who should and want to work.

The CHAIRMAN. So, based on your statistical evidence, women have been the chief beneficiaries of equal opportunity laws because they had historically been excluded as well?

Mr. JACOB. That is correct.

The CHAIRMAN. The President talked about welfare, and you have made an interesting statement about how you view welfare. What is your policy? Frankly, this Member of Congress was quite happy to hear the President talk about examining welfare.

I was saddened that he was going to do a study group. I thought he might come forth after 5 years as President with some specific proposals. Would your organization be willing to look at welfare reform?

Mr. JACOB. Yes, Mr. Chairman. First of all, we would be the last to sit here and to try to defend the way welfare is presently administered. Clearly, it is demeaning, clearly, it forces men out of the household, clearly it has a lot of negatives, but it happens to be the only game in town, and therefore, while we have problems with the way it is presently structured and administered, you don't get rid of it, you change it and improve it.

Immediately after the President announced that he was going to set up his study group and announced who would chair it, chills ran through me and my organization. Keep in mind who chairs the domestic council. The Attorney General has been opposed to practically everything that this group has needed over the last 5 years, so we have a great concern about the makeup of the study group.

If, in fact, it were to be studied, and I would agree that one would expect the President to come with a proposal rather than a study group, but even if it were to be studied, I think there are people independent of the administration and knowledgeable about the subject who could study the subject and make recommendations for changing how welfare is currently being administered.

I think, clearly, there are some changes that are needed. Clearly, there are some things that could be done, but I also remind us that welfare, even in the most generous States, as I have attempted to say today, is still less than what is the Nation's poverty line.

No one is getting rich on welfare, and the examples that are constantly bandied about to illustrate that there is some dishonesty in the receipt of public welfare, I would remind this committee and the country that welfare is not unique in that respect, and that indeed, we have to keep in mind that AFDC in particular, and poverty generally, have become programs that are impacting our youth, and without a program to deal with young people who are coming into the world, we weaken our position to remain competitive in a world economy.

The CHAIRMAN. One last question, Mr. Jacob. I am glad to hear you say that your organization is willing to join in a realistic attempt to examine welfare and to get disincentives out of it. This will allow people to get back to work.

Let me ask you one other question with regard to the issue of educational priorities in this budget. As you know, student financial assistance for needy college students would be cut by almost $1 billion. In the Pell grant program alone, which is the program directed at the neediest students in our society, 290,000 low-income students would be denied assistance if these particular cuts were made. The President proposes at the same time a policy shift in education to tax favored savings accounts for higher education and tuition tax credits for private education. Does this policy shift bother you and what is your reaction to these proposals? What does it do in terms of providing opportunity for the constituency group that you have been a spokesperson for the last two decades?

Mr. JACOB. I am deeply troubled by all of those proposals, Mr. Chairman. First, in terms of blacks entering into college, I remind you again that a few years back, we were almost at parity with black high school graduates and white high school graduates entering college.

The cuts that have come about in the last 5 years related to education have changed that situation to the degree today where some 52 percent of white high school graduates are entering college, but only some 36 percent of black high school graduates are entering college, so we have already increased the gap between blacks and whites who are entering college.

That gap will continue to increase when we understand that the overwhelming majority of black children aspiring to go to college from those households that are made up in those statistics that can be identified as less than middle class, so without those moneys being made available, we weaken the capacity of black kids to go to college.

Second, in terms of what is happening to our black and poor kids in public education and the impact that the voucher system and the income tax credit will have on them will be devastating.

First, it will drain out of the public school system those black kids that can provide an intellectual integration in our community.

Second, Mr. Chairman, I would point out to you that the amount of money involved is extraordinarily low. If I remember the number correctly, it is about $600 a year. Now that—I don't know of any private school where a child could go for that amount of money, so that is a supplemental program for those families that are already able to afford to send their children for private education. It is not designed to raise the performance levels or to change the educational experience of poor, inner city kids, be they black or white. The strategy simply is not designed to address those children and those needs.

I would also argue, Mr. Chairman, that America is making a grave mistake by sacrificing poor children generally, and black kids in particular, to inadequate education. I spent some parts of October and November in east Asia. I was in China, Vietnam, Taiwan, Hong Kong, Korea, Thailand, the Philippines. What impacted me the most in those countries was the traditional craft and manufacturing jobs that in the past people who had limited education and limited skills could get are being done in those countries, being done so much cheaper, and it is being done as well if not better.

Now, what does that say to us? It says that that market is no longer available to us, and if America is to compete in the world market, we have to find another niche. That niche is for us—it seems to me that we have to produce a group of smarter children, more analytical and more technologically literate, because we have to be able to produce at a higher level of performance.

And I remind America that one-third of the workforce in the very near future will be minority. The pool of white males is dwindling significantly.

The one thing that I do agree with the President on is that you can indeed pick up the newspaper here in Washington or in New York on Sunday and see pages and pages of want ads. We come to different conclusions, however, and the conclusion that I come to is that we are seeing all of those jobs going begging because we no longer have the pool of people to fill those jobs.

In order to fill those jobs, we are going to have to broaden the pool. To broaden the pool, we are going to need access to minorities and women in greater numbers, because that is where the workforce of tomorrow is coming from and unless we provide them with the education, unless we provide them with the training, we will not have the labor market to compete in a world market, we will not have the employment levels in this economy to consume the products and the goods and services that are being provided, and we will be in serious trouble economically as well as socially.

The CHAIRMAN. Mr. Jacob, we want to thank you for your testimony, and for taking time to come and appear before the committee today. Certainly your concerns and your points will be taken into consideration when we begin to mark up the budget of the United States.

We are also glad to hear that your organization does stand strongly for deficit reduction. Thank you very, very much for your attendance, as well as your testimony.

Mr. JACOB. Thank you, Mr. Chairman.

The CHAIRMAN. The committee stands adjourned.

[Whereupon, at 2:40 p.m., the hearing adjourned until Tuesday, February 25, 1986.]

IMPACT OF THE PRESIDENT'S 1987 BUDGET

TUESDAY, FEBRUARY 25, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:12 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee), presiding.

The CHAIRMAN. The Budget Committee will now come to order. Today we begin the final week of hearings to consider the budget choices which must be made in the budget resolution for fiscal year 1987.

We will be hearing from a broad range of individuals this week—our colleagues in the House of Representatives; the Chairman of the Federal Reserve Board, Mr. Volcker; David Maxwell, Chairman and Chief Executive Officer of the Federal National Mortgage Corporation; Governors, bipartisan Governors of four States; a bipartisan delegation of mayors of four cities; and several private citizens.

During the past several weeks this committee has heard a variety of views on the budget around the country. We have been told that reducing the deficit is a high priority, but it is not an exercise which can be done mindlessly and mechanically.

We are called on to make the decisions on spending and taxing now, and not wait until there is a crisis brought on by intransigence and posturing. We must try to put aside partisan bickering in order to shape a budget which will put the economy on a course toward sustained prosperity.

I am pleased to welcome as our first witness today the chairman of the Joint Economic Committee, Representative David Obey of Wisconsin. He is a former member of this Budget Committee.

Before we begin, I would like to congratulate Chairman Obey on presiding over the Joint Economic Committee during its 40th anniversary year, and on the excellent symposium on economic policy held by the Joint Economic Committee earlier this year.

I understand that Vice Chairman Abdnor is unable to be with us today, but that he will submit a statement for the record. I am sure that Congressman Obey has a great deal of wisdom about the economy and Federal fiscal policy to pass on to us. Mr. Obey, I am particularly interested in hearing your views, on the impact which Gramm-Rudman will have on fiscal policy.

We are pleased to welcome back to the Budget Committee room, one of the outstanding Members of the House of Representatives, the chairman of the Joint Economic Committee, and a distinguished former member of the Budget Committee. Congressman

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Obey, we welcome you and we invite you to summarize your testimony because it will be submitted in its entirety for the record.

STATEMENT OF HON. DAVID R. OBEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN AND CHAIRMAN, JOINT ECONOMIC COMMITTEE

Mr. OBEY. Thank you, Mr. Chairman.

First of all, let me observe that this room has changed somewhat since the last time I have been here. I understand it is now called the Gray Room. [Laughter.]

The CHAIRMAN. These days, that is true.

Mr. OBEY. I do have a statement from Vice Chairman Abdnor which I would like to submit immediately following my testimony.

The CHAIRMAN. Without objection.

Mr. OBEY. I would like to summarize my statement. I thank the chairman for his kind comments in his introduction. I appreciate the very forceful and effective leadership he has provided this committee and the Congress since he ascended to the chairmanship about 2½ years ago.

Mr. Chairman, I think it would be appropriate for me, since the administration has reported to Congress its views on the state of the economy and its predictions for future economic performance, if I were to make some comment on the administration's evaluation of existing economic conditions.

I think to evaluate the administration's numbers, it is necessary to put those numbers in historical context.

On the issue of growth, the administration predicts an economic growth rate of about 4 percent each year for the next 5 years. As you know, the fact is from 1981 to 1985, GNP grew at a real rate of about 2.3 percent. That compares to a 3.1-percent growth rate during the preceding 5-year period and a 4.2-percent growth rate in the 1960's. I doubt that it is prudent to assume that we will have economic growth every year for the next 5 years which is significantly in excess of the growth rate we have had for the vast majority of years since the end of World War II.

Productivity: The administration predicted last year that productivity would grow by 1.7 percent. In fact, there was virtually no growth in productivity last year. The annual rate of gain in productivity has been a weak 1.3 percent since 1979 down from a weak 1.5 percent during the previous decade and 2.9 percent in the decade before that.

On inflation, there have been significant gains. As we know, they have come at a terrific price in terms of recession, lost jobs, and lost output. I would also note that the reduction in inflation is not being sufficiently reflected in lower interest rates. Interest rates have certainly declined significantly in nominal terms over the past 5 years but the real interest rates are still some 2 percent higher than their postwar average.

On savings, the crucial goal of supply-side economics was to increase the savings rate and yet personal savings rate for the last two quarters has dropped to slightly less than 3 percent, the lowest since 1950.

On jobs, the administration prides itself on the creation of 10 million jobs since the recovery began in 1982, and yet when you factor in the 3.5 million jobs that were lost before the recovery began, the total net job growth of 6.5 million represents about half the rate of job growth that we had in the previous 5-year period.

On trade, the current account deficit for 1985 is about $125 billion, nearly twice as large as a percentage of GNP as it has been in this country's 210-year history. Everyone is aware on the debt side of what our Government debt situation is. I think it is important to note that that is replicated on the private side of the economy. By the end of 1985, the American corporations will owe a total of $1.5 trillion, the highest in history. Corporate debt exceeds total net worth by 12 percent. Household debt has tripled in the past 10 years. Farmers have taken on $21 billion in debt since the 1970's, and owe the Farm Credit System $67 billion and yet farm income is continuing to decline. International debt for the United States is relatively a new experience, at least in the century, yet we owe the rest of the world approximately $100 billion for 1985.

In terms of equalities in the economy, there has been a significant increase in the equality of income and opportunity over the past 10 years. According to the Census Bureau, the gap between the richest American families and the poorest now stands at its highest level since 1946.

There are other measures of economic performance which are in my prepared statement.

What I would like to do for my remaining time is address a few other questions.

The President has asserted continuously that the deficit is as high as it is today because the Congress has exceeded his request for spending. I have a chart behind this chart, if you would take the first one down, which demonstrates in the pink, the appropriation request which the President has made of the Congress each year for 5 years.

The line to the right indicates that in fact over the last 5 years, the President has requested that Congress appropriate some $3 billion more than we have actually appropriated.

In my judgment, if we are—and I do believe we are in debt far in excess of where we can afford to be—it is not because the Congress has refused to listen to the President's suggestions on spending but precisely because the Congress has listened to the President's suggestions on spending.

My third observation would be that the President's budget itself appears to miss the Gramm-Rudman deficit reduction targets and therefore could very possibly result in sequestration even if we adopt the President's budget without changing a comma, because as you know, the President's budget apparently underestimates defense outlays by some $14 billion, which means we miss the $144 billion deficit reduction target laid out and required of us under Gramm-Rudman, and also because the President's growth estimates still exceed most of those in the private sector.

I find that highly disturbing. When the executive branch punts, so to speak, on its major role in the budget process, that means that the chance for the budget process to work effectively is greatly diminished. I do not believe that the Congress in and of itself has

the leverage to enable it to protect the country from a vast misallocation of resources and priorities and vast misjudgments in spending in and of itself without the assistance and cooperation of the executive branch.

The budget process takes a lot of heat. Unfortunately, that heat is usually focused on the congressional side of the stove rather than being focused on all of the burners of the stove including the Executive's role.

I think perhaps one reason that the administration has missed the Gramm-Rudman targets is because it probably knows that its own spending priorities are inconsistent with the Gramm-Rudman numbers. I would like to demonstrate what I mean by that. Just put this other chart back up again. Thank you.

This chart indicates the allocation of resources in the 1980 President's budget versus the budget which the President submitted earlier this month. If you start with the green piece, the green portion of the pie represents the 7 cents out of every dollar that went in 1980 for budget programs for the nonelderly poor. As you can see under the President's budget for 1987, which is the circle on the bottom, the pie on the bottom, that portion of the budget has shrunk from 7 cents out of every dollar to 5.5 cents out of every dollar.

The white wedge indicates on the top circle the 9 cents out of every dollar that went for interest payments in 1980 versus the almost 15 cents out of every dollar that will go for interest payments under the President's budget this year.

The red piece represents the one part of the budget that has not changed. As you can see on the top, in 1980, all programs for the elderly and disabled took approximately 37 cents out of every budget dollar. In the President's 1987 budget request, that remains the same, 37 cents out of every dollar.

In contrast, in 1980, the blue piece represents the amount that was allocated to defense, foreign aid and foreign operations, maintenance of embassies, things like that. That represented 25 cents out of every dollar in 1980. Today it represents over 31 cents out of every dollar, which gets you to the remaining portion of the budget, which is represented by the gray wedge.

That remaining portion of the budget was 21 percent of the budget in 1980. Now in the President's budget for this year it would come in a little under 11 percent. That would mean we would have effectively, if we adopted the President's budget, we would have cut in half that remaining portion of the budget, which contains two vital functions of Government.

The first function is the day-to-day operation of agencies from Internal Revenue to the Customs Service, drug interdiction, maintenance of prisons, things like that. It also contains what I consider to be the investment portion of the budget, everything we invest in. Kids, by way of education. Everything we invest in science research, be it research to keep us on the cutting edge of technology change or research to keep us on the cutting edge of medical scientific progress to prevent human disease and to cure human disease.

It represents everything that we invest in workers by way of training. It represents everything that we invest in our community infrastructure by way of highways, sewage treatment plants and

the like to enable our communities to be places where business can make a buck and where workers can earn an honest decent wage.

As you can see, that is the portion of the budget upon which the lion's share of the reductions are being focused. I believe that by focusing on that portion of the budget, we are diminishing our opportunity for this economy to grow sufficiently in future years and we are not effectively positioning ourselves to compete economically.

I think this budget represents a good prescription for winning the war against the Russians in terms of the arms race. But I think it presents a very bad prescription for winning the other war that we are fighting, the economic war against our economic competitors, be it Germany, Japan, Korea, you name it. What that means is you have left in that portion of the budget, if we adopt the President's budget lock, stock and barrel, only about $110 billion, and yet we will still under Gramm-Rudman be left with a deficit of $144 billion, which would mean that if you eliminated that entire investment portion of the budget, which is the only major portion of the budget which is absorbing major reductions as a percentage of the budget, if you eliminated it, we still would not be to the Gramm-Rudman deficit targets by 1991 of zero deficit.

I think that indicates there simply is not enough remaining in that portion of the budget to reach the Gramm-Rudman target if we are going to continue the policy recommendations laid out in the President's budget.

I would like to make some comments if I could, and these are largely personal, on the Gramm-Rudman proposal itself. As you know, Gramm-Rudman requires us to reach a zero deficit target in nominal terms by 1991. I personally believe that is the wrong target if the purpose is to maximize economic growth.

I think we ought to ask ourselves why we are going through this deficit reduction process. I think the reason we are doing it is because we believe that deficits at their existing levels threaten the ability of the economy to grow as fast as it would grow if we were under a more sane fiscal situation.

The belief of the vast, vast majority of economists who testified at the JEC symposium 2 months ago, was that if you want to reach the real deficit target and if you want to determine what the deficit is that really has an effect either up or down on the economy, you ought to examine not the nominal deficit but you ought to examine the deficit as it would exist at full employment adjusted for inflation.

There are a number of members of my committee who do not agree with that. Those are my views for good or for ill.

And I would say that economists ranging from Herb Stein and Paul McCracken, on the conservative side, to Bob Eisner and Allen Blinder and a number of others, on the liberal side, indicated their agreement with that basic judgment when they testified before the JEC at our symposium.

I think it is essential for us to remember that budgets are not just balance sheets. They also represent investments. They represent the priorities. They represent values, at least they ought to in a country as sophisticated as ours.

In terms of what we ought to be doing, I do not want to suggest to this committee what it ought to be doing to deal with the budget deficit situation. Let me simply say where I think we ought to wind up in the end, after all of the Alphonse and Gaston routine is finished between us and the White House.

Where I think we ought to wind up is essentially with a budget freeze across the board, covering virtually everything. I believe that if you did that you would have a sense of shared sacrifice in the country. And then I, personally, would make up the remainder of the difference with increases in revenue.

Let me stipulate that I know of no one who is talking or advocating an increase in individual income taxes, for instance. But I do think that there are a variety of revenue sources which could be reviewed.

I do think, for instance, that it would be possible—even if we proceed with the tax reform bill—I think it would be possible to delay—even if we want to put the lower rates into effect and put them on the books—I think it would be perfectly responsible to delay the actual implementation of further rate cuts until we have at least cut the budget deficit in half.

We could also consider some form of reaction to the energy situation, which has now happily befallen us, on either the oil import side or the gasoline side. I think—and frankly, this probably sounds like heresy coming from a liberal or a progressive—I would personally be opposed to a business transfer tax standing alone. But I would be very interested in exploring the possibility, long term, of a business transfer tax if you could make that tax progressive rather than regressive—as it would be if it were standing alone—by providing some kind of offsets, for instance, using some of the revenue to exempt the first few thousand dollars of income from Social Security taxes.

I think that kind of an approach, long term, would have the advantage of dealing simultaneously with our trade deficit, with our budget deficit, and also give us an opportunity to turn the most regressive tax in our system at this point, the Social Security tax, into a more progressive tax.

I think if we do not face up to the fact that we have to deal eventually with both the spending and the revenue side, that we are going to shut off economic opportunity for a whole generation of people. I think we have got to face up to the fact that really, since 1973, neither political party has known how to run an economy in such a way that you could deliver to the American people an economy truly running at a full employment level on a noninflationary basis.

As a result, we have discovered some very disturbing things. Example, I graduated from college in 1960. At that time, the average 30 year old worker, who had left the family nest 10 years earlier, was making on average about 30 percent more than his father was making when the kid had left home. Today, that same 30 year old worker on average is making about 10 percent less than he was making when he left his father's home 10 years earlier.

I am convinced that unless we are willing to set aside each party's ideological first preferences and try to reach accommodation early in the game on that grand compromise between the

White House and the Congress, that we simply run the risk of continuing the economic uncertainty in the country, continuing the budget uncertainty. And I think we run the risk of putting together a very sloppy, sloppy package because we will put it together so late in the cycle that we will not be able to do it with the degree of thought we would be able to apply to it if we were able to come to a compromise between the White House and the Congress now.

And as I said, I believe that that means that we have to have both spending reductions across the board, covering absolutely every program, not exempting the major big ticket items on either the entitlement side or the military side. And it certainly means that we have to deal with the revenue side of the equation as well.

[Testimony resumes on p. 609.]

[The prepared statement of Mr. Obey follows:]

Prepared Statement of Hon. David R. Obey

Pursuant to section 301(d) of the Congressional Budget and Impoundment Act of 1974, I am pleased to make the following report as Chairman of the Joint Economic Committee concerning the fiscal policy expressed in the President's Fiscal Year 1987 budget submission and the implications which that policy has for meeting the goals expressed in the Employment Act of 1946.

The views which I am expressing are being sent today to Members of the Joint Economic Committee for their review and concurrence as part of a larger report which the Committee is preparing on overall economic policy. That report is mandated by the Employment Act of 1946 as a response to the Economic Report of the President. The President's report was signed and transmitted less than three weeks ago. We hope to have the concurrence of a majority of the Committee Members on the full report by early next week.

There is strong bipartisan agreement on the Joint Economic Committee that the fiscal policy of the Federal Government over the last several years has been far too expansionary and that the failure to take significant steps to reconcile the gap between federal revenues and federal spending poses a significant danger to the sustained health of the American economy. These dangers include:

* Growing U.S. dependence on foreign lenders.

* Higher interest rates than would be otherwise necessary.

* Rapid growth in both the national debt and in the portion of the budget required to service that debt. Clearly the cost of debt service will significantly reduce our ability in the coming decades to use public policy to address a wide range of social, military and economic problems.

* Continued damage to U.S. manufacturing interests accompanied by the continued loss of high wage and salaried jobs in those industries. This is a direct

result of the extraordinary and prolonged misalignment of our currency against the currencies of our major trading partners.

There is also bipartisan agreement that under current economic conditions, the deficit reduction required for Fiscal 1987 under Gramm-Rudman appears to be appropriate.

Based on a review of the Office of Management and Budget and the Congressional Budget Office baseline budget projections and a variety of current economic forecasts, I believe it is clear that the degree of fiscal tightening necessary to meet the $144 billion deficit target can be achieved without significant ill-effects to the economy and with considerable short- and long-term benefits.

I know that many of the Democratic Members of the Committee, and perhaps some of my Republican colleagues as well, share my concern that the budget that the President has submitted does not contain the level of restraint mandated under the law. Specifically, it fails to meet the agreed maximum deficit target for Fiscal 1987 which the President himself called on the

Congress to enact and which he signed into law less than three months ago.

We further believe that enactment of the Administration's Fiscal 1987 budget could very easily result in the issuance of a sequestration order for the fiscal year beginning this October under the terms set by the new legislation.

One reason why we believe this budget risks the chaos which would be created by sequestration is the estimate which it contains for defense outlays. The $282 billion estimate for defense understates the real cost of the President's budget proposal in this area by $14.5 billion according to the Congressional Budget Office. While CBO has not yet completed its re-estimation of the entire Executive Budget, it would appear that the deficit which the President is asking us to enact is more in the range of $158 billion based on the Defense re-estimate.

A second reason that the budget poses a significant risk of sequestration is the economic forecast on which the budget is based. That forecast, as most of you know, was significantly out

of line with the consensus forecast at the time it was issued. Since that time, the rapid and unexpected decline in oil prices has given us a boost that has helped close the gap between what private forecasters are suggesting and the forecast upon which the Administration's budget is based. This means that the Administration's forecast is now only .5 to 1.0 percent above most private sector forecasters in their projections of real growth between now and the end of Fiscal 1987. The possibility of reduced oil prices makes the Administration's economic forecast, in the words of economist Alan Greenspan, "not improbable."

But being, "not improbable," is not the same as being prudent, particularly in the era of Gramm-Rudman. If private forecasters are right and the Administration is wrong in its rose-colored view of the next 21 months, an additional $10 to $20 billion will be added to the deficit. While part of the sequestration risk from over-optimistic projections could be resolved by simply having OMB and CBO maintain an optimistic view of economic growth in their August re-estimate, regardless of economic realities, the most important quarters for determining

how much revenue the government will collect in fiscal year 1987 will occur between now and August. If, for instance, real GNP growth were to remain relatively flat -- at the 1.2 percent level we experienced in the last quarter -- the growth forecast for fiscal 1987, which would be required of CBO and OMB in their August reports to prevent a decline in estimated 1987 revenues, would be in excess of 6.5 percent.

We find the Executive Branch's failure to submit a budget which meets the Gramm-Rudman targets deeply disturbing since such a large majority of the budgetary expertise and resources needed to find deficit reductions are allocated to the Executive Branch of government. There is far too little attention in the public debate over the Federal budget to the fact that the Congressional Budget process passed in 1974 was created to supplement, not replace, the Executive budget process.

In 1921, the Appropriations Committees rebelled at the fact that each agency of government submitted its own independent spending request without approval or clearance from the White House. The 1921 Executive Budget Act directed the President to collect those requests, revise them and submit them in aggregate

to the Congress. The Employment Act of 1946 further strengthened the President's legal responsibility in establishing federal budget policy.

While Congress needed a far more effective means of responding to Presidential budgets than was true prior to 1974, the Congressional Budget Act was not intended to diminish the basic role of the President in preparing or presenting the Executive budget. The burden for taking the first and most important step in structuring a viable budget still rests with the President. This is true not only as a matter of law but also in terms of the resources which have been made available to the President for the purpose of budget preparation.

When the Executive Branch effectively punts on its leadership role in the budget process, it is extremely unlikely that the Congress alone has leverage necessary to prevent an ineffective and unbalanced use of tax dollars. The system is simply not set up to work that way.

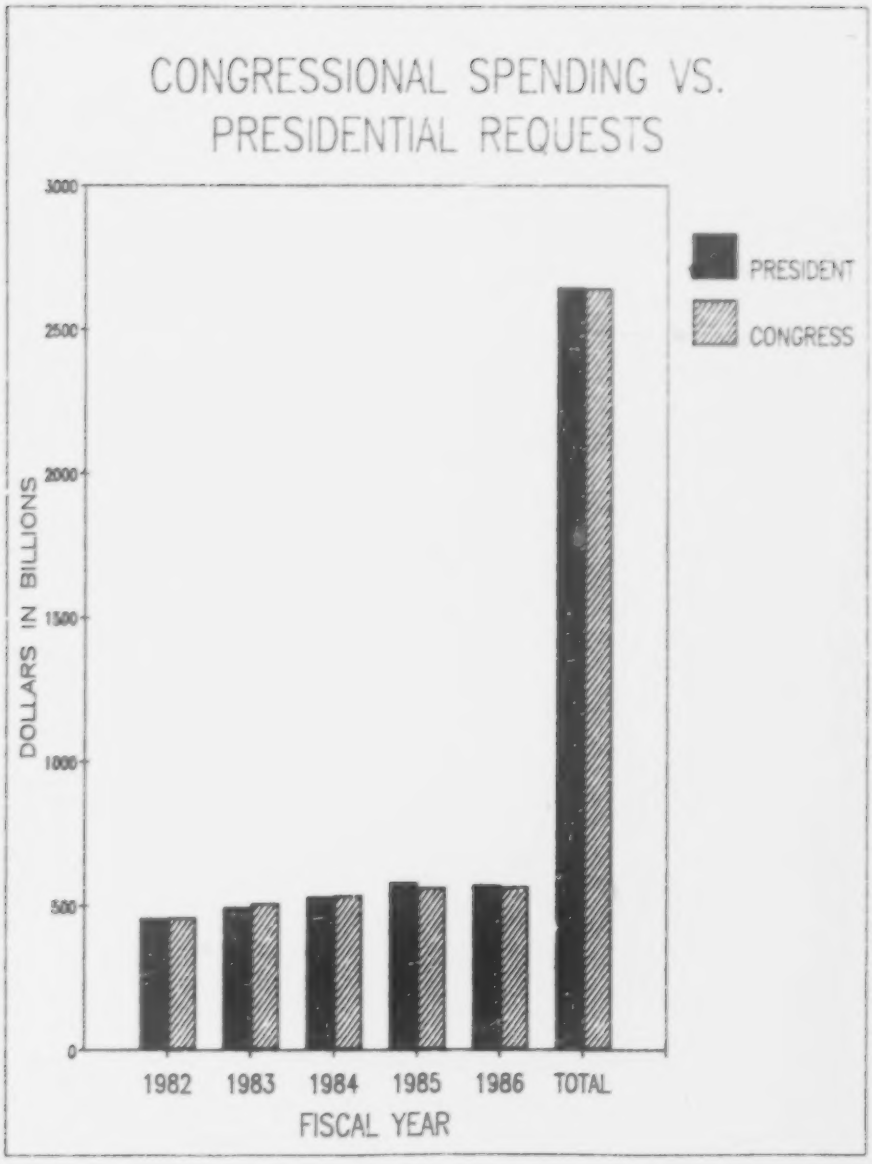
Producing a good Executive budget requires not only the Administration's best judgment on issues of substance; it also

requires considerable skill in determining how the Executive and Legislative Branches can arrive at an agreement that reflects the best collective judgment of both Branches on what the Nation's priorities and fiscal policy should be. When budgets are repeatedly rejected by actual or near majorities of the President's own party, it is a good indication that the Administration has failed on both counts.

It should also be emphasized that contrary to what the Administration says about the origins of the deficit problem, the fact that both Houses of Congress have in recent years rejected the Presidential budgets does not mean they have voted for higher levels of spending. Graph A shows that in only one of the last five years has the Congress appropriated more than the Administration requested, and overall the President has received, $3 billion less in appropriations than he has asked for.

Perhaps one reason for the Administration's repeated submission of "dead-on-arrival" budgets and its failure this year to meet the deficit reduction target required under Gramm-Rudman, is that the Administration's stated priorities in terms of

GRAPH A


CONGRESSIONAL SPENDING VS.
PRESIDENTIAL REQUESTS
3000
2500
2000
1500
1000
500
0
DOLLARS IN BILLIONS
PRESIDENT
CONGRESS
1982
1983
1984
1985
1986
TOTAL
FISCAL YEAR

spending and tax legislation cannot be reconciled with its stated goals in fiscal policy.

This can be easily illustrated by Graph B which compares 1980 spending with the 1987 request. It was prepared with the very valuable assistance of the House Budget Committee staff.

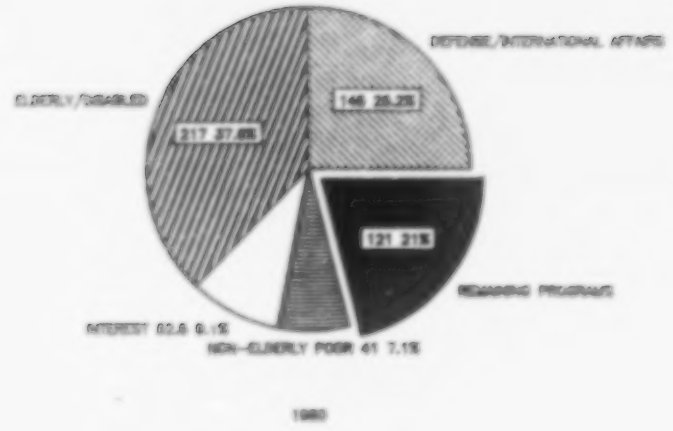
Graph B disaggregates the budget in terms of categories that describe the purpose and beneficiaries of each type of Federal spending more clearly than the technical terminology in which we normally deal. For instance, the term "transfer payments" which is usually used, describes a mechanism of budgeting, but does not describe who is getting what and for what purpose they are getting it.

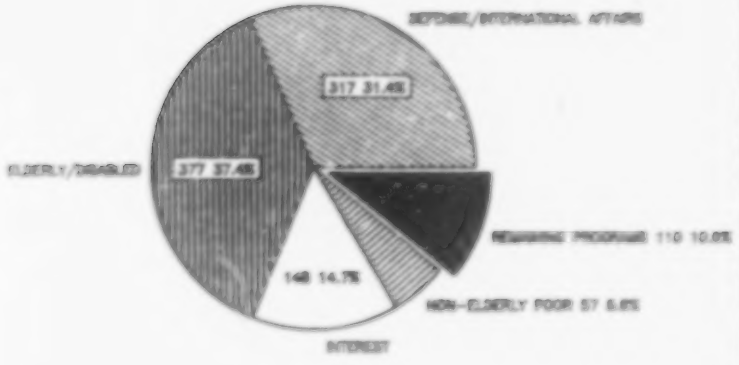
Graph B demonstrates the following:

* Spending for non-elderly poor has increased in nominal dollars but has declined as a percentage of the budget and has declined in terms of per capita real dollars because of the increased poverty we have experienced during the 1980's.

GRAPH 3

BUDGET OUTLAYS
1980 VS. 1987 PRESIDENT'S BUDGET
(BILLIONS OF DOLLARS)





* Spending for the elderly has grown in nominal terms but has stayed constant as a percentage of total budget.

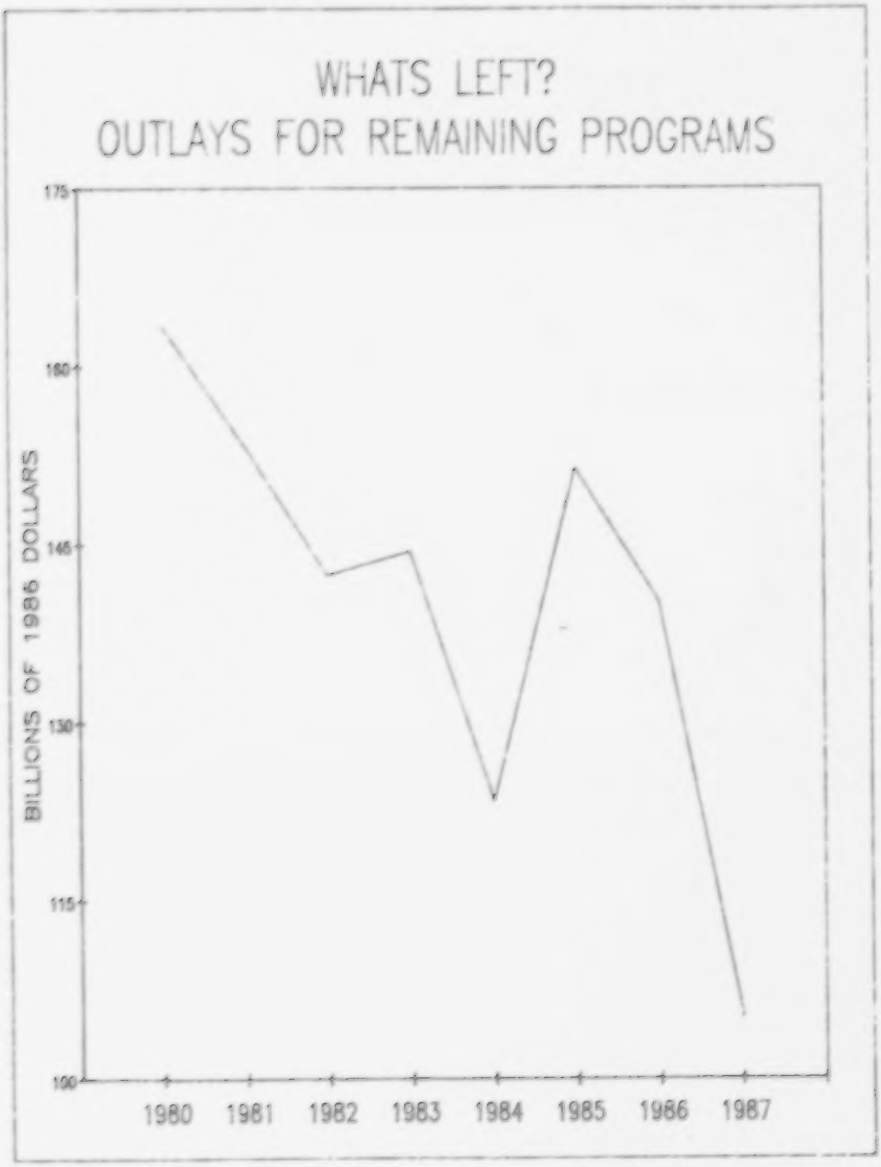
* Spending for two other categories, defense and foreign affairs, and interest on the debt have grown in nominal terms and as a percentage of the total budget.

That means that the major part of the budget that is being squeezed is the portion that contains two functions:

(1) the day-to-day operation of vital government activities which range from tax collection and drug interdiction to environmental enforcement and law enforcement, and

(2) investment in activities that increase America's ability to compete for the remainder of this century. That includes everything we invest in the development of our children by way of education; everything we invest to expand our scientific knowledge --whether it is knowledge to keep us on the leading edge of technological change or knowledge to improve our

GRAPH C


WHATS LEFT?
OUTLAYS FOR REMAINING PROGRAMS
BILLIONS OF 1986 DOLLARS
175
160
145
130
115
100
1980
1981
1982
1983
1984
1985
1986
1987

prevention and treatment of cancer and other dreaded diseases. It includes investments in the things that make our communities places where business can make a buck and provide jobs -- investments like roads, sewage treatment facilities, etc.

Under the President's recommendations, this remaining portion of the government's budget (operations and investment) will have been cut in half as a percentage of the total budget since 1980. In addition to being slashed as a percentage of the budget, the purchasing power of the dollars in this budget category will have been reduced by more than one-third in real dollar terms.

The Congressional Budget Office has indicated that even without the President's new budget, domestic discretionary programs have been reduced from a high of 5.8 percent as a percent of GNP in 1980 to 4.1 percent today. That puts it below the 4.2 percent level that prevailed in 1962 before any of the Great Society programs were enacted. Under the CBO baseline it will decline to 3.4 percent of GNP by 1991. Under the President's new budget it will shrink to 2.7 percent.

But the most important information these charts provide is that the Administration's professed budget priorities are clearly inconsistent with their espoused fiscal policy goals as well as the legal requirements in Gramm-Rudman.

The President says that he will maintain a social safety net for the truly needy. The President has also said, and most recently Secretary Baker has testified before your Committee, that Social Security and entitlement programs must be maintained and the charts indicate that the retirement portion of the budget has been sustained. Interest will continue to grow with the growth in the national debt, and we are all familiar with the President's position in insisting on significant increases in defense and foreign aid. In terms of new budget authority he is asking more than 8 percent real growth in defense for the coming year alone.

Most of the cutting has to continue to come from the small portion of the budget that has already been savaged for the last five years. Clearly, even the White House is beginning to feel uncomfortable with what is happening with that portion of the budget. They could have actually reached the $144 billion Gramm-

Rudman target without shaving $14 billion from the defense outlay estimate if further cuts in the "remainder" category were less painful to them.

The thrust of Administration budget policy has clearly been to shrink the investment portion of the budget. But the big problem is that even if you meet Gramm-Rudman targets in 1987 you still have $144 billion in deficit reduction to go and only $110 billion is left in the only major portion of the budget this Administration has targeted for shrinkage.

Of course the Administration has an easy answer. They say that if we only make the cuts which they have asked for in Fiscal 1987 that the budget will balance itself by 1991. In other words, we are back to the old argument that "we can grow out of it."

How realistic is that assertion?

Well, the average growth rate over the first five years of this Administration has been 2.3 percent annually. But the Administration is predicting a 4 percent growth rate annually each year between now and 1990. That rate of growth would be 74

percent higher than the average rate of growth we have experienced since this Administration came into office. Such a sustained level of high growth would be an extraordinary event in our Nation's economic history and constitutes a prediction which virtually no reputable private forecaster is willing to either join in or even approximate. Since 1981 this Administration has repeatedly told us that we should expect long-term growth at levels far above those we have averaged since the end of World War II. Instead, we have experienced growth well below the post-war average.

Most recently, the Chairman of the President's Council of Economic Advisers announced half way through the fourth quarter of 1985 that the Administration would stick with its forecast of 5 percent growth in the last half of 1985 because growth in the fourth quarter would be between 5 percent and 6 percent. Numbers released 10 days ago showed actual growth in the fourth quarter was only 1.2 percent indicating an error in forecasting of more than 3.8 percentage points. It is difficult to understand how the Administration can exude confidence in long-term forecasts so far out of line with the concensus of private forecasters, the

Nation's economic history and the economic history of this Administration when their current quarter judgments can be off by nearly 4 full percentage points.

Even if the Administration is correct, there is one major point that it fails to mention in urging the adoption of this year's budget. A high growth forecast can result in a balanced budget by 1991 with no cut below current services at all.

Table II-5 on page 70 of the CBO "Economic and Budget Outlook: Fiscal Year 1987-1991," illustrates the budgetary impact of varying economic forecasts. A high growth scenario used by CBO would involve six years of growth ranging from 4 percent to 4.6 percent. The average forecast for each of the six years is 4.4 percent. This forecast would result in a $70 billion budget surplus by 1991 if the White House and the Congress make no cuts at all below current policy. The Administration's 4 percent forecast would bring the CBO baseline budget to roughly a zero deficit with no spending cuts either this year or in the future.

Clearly, those of us concerned about the present course of fiscal policy would find it more prudent to look at what would

SUMMARY TABLE 4 ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

TABLE II-5 CBO BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	1991
Revenues						
High-Growth Alternative	784	866	971	1,086	1,228	1,403
CBO Baseline Projection	778	844	921	991	1,068	1,144
Low-Growth Alternative	777	818	828	882	948	995
Outlays						
High-Growth Alternative	985	1,020	1,082	1,147	1,229	1,333
CBO Baseline Projection	986	1,025	1,086	1,135	1,188	1,248
Low-Growth Alternative	987	1,042	1,111	1,153	1,185	1,232
Deficit						
High-Growth Alternative	202	154	111	61	1	-70a/
CBO Baseline Projection	208	181	165	144	120	104
Low-Growth Alternative	210	224	282	271	238	237

SOURCE: Congressional Budget Office.

a. Surplus

happen to the deficit if growth over the next five years were roughly similar to what we have experienced over the last five years, that is roughly 2.3 percent. That happens to be only slightly above (five hundreths of one percent) the average of the yearly projections in CBO's slow growth scenario also on Table II-5. Under that scenario deficits would rise from current levels to $237 billion by 1991 with no change in policy.

The safest course for responsible policymakers concerned about the deficit is to not assume that growth alone will take care of our problems.

But if the President insists that most spending cuts must come from one small portion of the budget, a portion containing less spending than the remaining deficit reduction required by Gramm-Rudman, how can this requirement be met?

There are three options:

(1) Increase revenues

(2) Force a re-examination by both Branches of government of the items that are off the table.

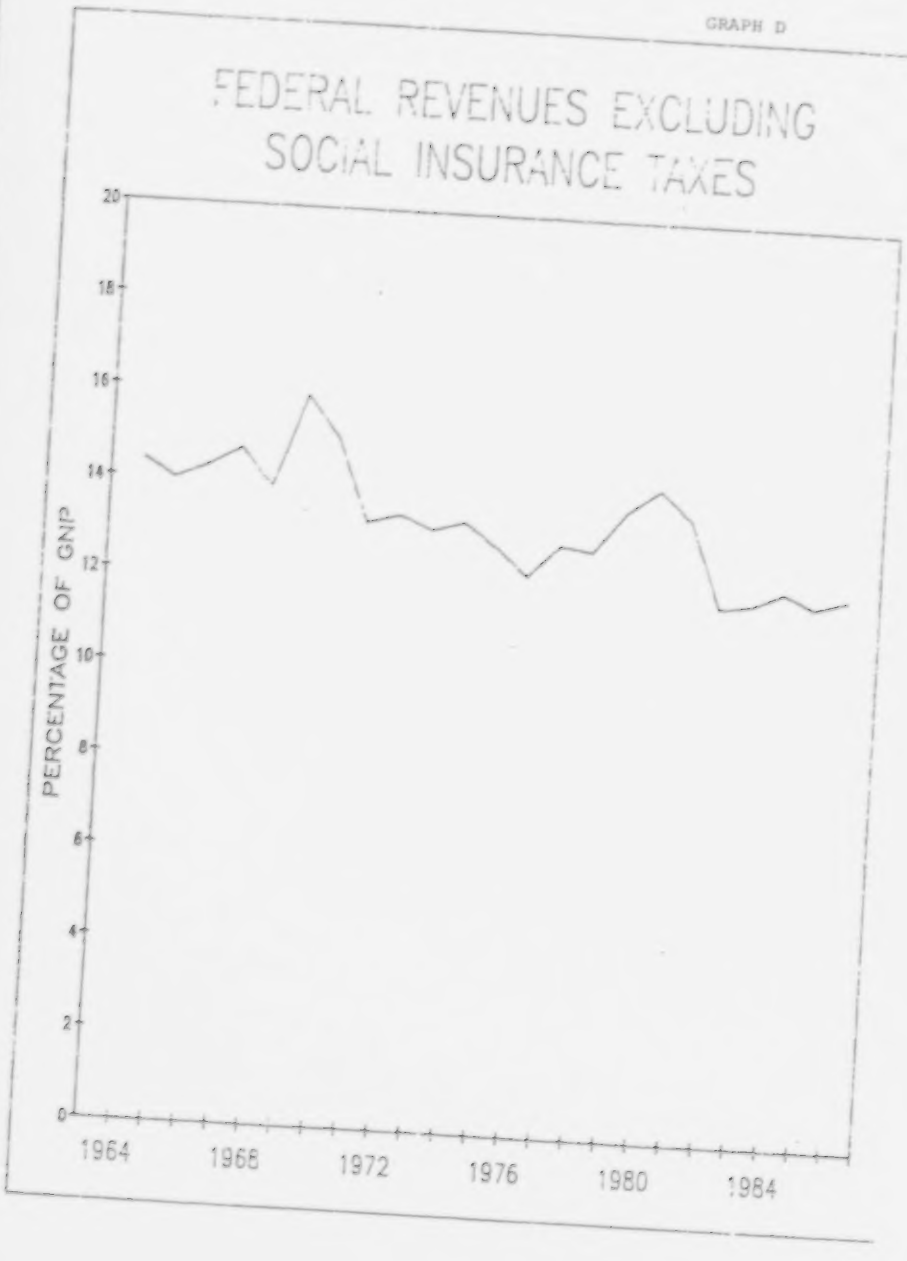
(3) A combination of the first two options.

We believe that the third option is the most certain path to restoring fiscal order. No one that I know of is advocating an increase in individual income tax rates. There are numerous methods of increasing revenues without raising individual income tax rates including changes in the revenue code which the Administration professes to support that would force individuals and corporations that are now not paying taxes to do so.

The Administration contends that the problem is outlays and not revenues. Outlays are a problem and have gone up, but as outlays have gone up general purpose revenues have declined. Revenues have dropped, as a portion of GNP, by 17 percent since 1981 and by nearly 26 percent since 1969.

The Administration has reported to Congress its view of the economy and its predictions for economic performance. In order to evaluate the conclusions reached by the Administration about present and future performance, it is necessary to put those numbers in historical perspective.

GRAPH D


FEDERAL REVENUES EXCLUDING
SOCIAL INSURANCE TAXES
PERCENTAGE OF GNP
20
18
16
14
12
10
8
6
4
2
0
1964
1968
1972
1976
1980
1984

Growth

The Administration predicts an economic growth rate of 4 percent each year for the next five years. The fact is that from 1981 to 1985 GNP grew at a real rate of 2.3 percent. That compares to a 3.1 percent growth rate during the preceding five-year period and a 4.2 percent growth rate in the 1960's.

Last year's growth rate was 2.3 percent, and the fourth quarter growth rate was a dismal 1.2 percent. Yet, the Administration had predicted 3.9 percent growth for the entire year.

As Herbert Stein recently said, "The rise of total output over the five-year period from 1980 to 1985 was not exceptionally large. In fact, it was less than in any five-year period ending before 1980; that is, in the post-war period."

These numbers demonstrate a pattern of slow growth throughout the entire five-year period. There is little reason to conclude that we are going to have uninterrupted growth at a 4 percent annual growth rate for five consecutive years.

Productivity

The Administration predicted last year that productivity would grow by 1.7 percent. In fact, there was zero growth in productivity last year. The annual rate of gain in productivity has been a weak 1.3 percent since 1979, down from a weak 1.5 percent during the previous decade and 2.9 percent the decade before that.

It has been more than 20 years since this country has experienced productivity growth at the pace the Administration is now predicting. If productivity growth is on the upswing, we have yet to see any evidence.

Inflation

Here there have been significant gains, but they have come at a terrific price in terms of recession, lost jobs, and lost output -- all of which continue to plague the economy.

Moreover, the reduction in inflation is not being sufficiently reflected in lower interest rates. Interest rates have declined significantly from their 1981 peaks in nominal

terms, but real interest rates are still 2 percent higher than their post-war average.

Savings

A crucial goal of supply-side economics was to increase the savings rate, yet personal savings rates for the last two quarters dropped to 2.9 percent, the lowest since 1950.

Jobs

The Administration prides itself for creating 10 million jobs since the recovery began in 1982. Yet, we lost 3.5 million jobs before the recovery began. The total of 6.5 million net new jobs created from 1981 to 1985 is half as many jobs as were created in the previous five years. The average number of jobs created per year from 1981 to 1984 was 1.3 million versus 2.8 million per year from 1976 to 1980. Job growth from 1981 to 1985 was the lowest in 20 years.

Trade and Current Account

The current account deficit for 1985 of about $125 billion is nearly twice as great a percentage of GNP as it has been in the country's 210 year history. Even during the 1870's railroad boom which we financed with a massive amount of foreign capital, the current account deficit was 2 percent of GNP as compared to a current figure of 3 percent.

Debt

Everyone is aware of what our government debt situation is, and I won't repeat it. But I do want to emphasize that there is a tremendous level of private debt hanging over our economy as well.

By the end of 1985, American corporations owed a total of $1.5 trillion, the highest in history. Corporate debt exceeds total net worth by 12 percent. Household debt has tripled in the past 10 years and grew at an annual rate of 21 percent in the first half of 1985 as compared to the previous trend rate of

about 13 percent. The 1985 ratio of consumer debt to disposable income reached a record 18.9 percent.

Farmers have taken on $215 billion in debt since the 1970's and owe the Farm Credit System $67 billion, yet farm income continues to decline.

International debt for the U.S. is a new experience, yet we owe the rest of the world approximately $100 billion for 1985.

Inequality

There has been an increase in the inequality of income and opportunity over the last 10 years. According to the Census Bureau, the gap between the richest American families and the poorest families now stands at its highest since 1946 -- the year they began keeping these statistics. In addition, families in the middle of the income scale received 17 percent of the national income, their lowest share since 1947.

Family Income There are a lot of ways of measuring the performance of the economy, but the one that probably matters the most is what is happening to real family income. Several studies

recently completed under the auspices of the JEC gave us a good deal of new information on that question. Since 1973 the typical middle-income family lost about 11 percent of their real income. Young people were particularly hard hit as were families with children.

A young man leaving home in the 1950's or 1960's could expect within 10 years to make 30 percent more than his father was making at the time the young man left home. But a young man today who left home 10 years ago will typically make 10 percent less than the income of his father when the young man left home.

The percentage of mothers of children who work increased dramatically. For those with children under the age of one it has almost doubled since 1975 to nearly 50 percent in 1985. Yet the total income of families with children has declined in real dollars for low-, middle-, and even upper-income families during that period. For all but the highest income families, the decline was most severe between 1979 and 1984.

We are a great Nation with vast resources and a willingness to work hard for ourselves, our children and our country. Even serious mistakes in fiscal policy won't change that, but we can do a lot better. Let's put aside our rhetoric, take an honest look at our problems and set forth in a practical way to solve them.

BUDGET OUTLAYS BY JEC-REQUESTED CATEGORIES, 1980-1987
(Dollars in Billions)

	FY1980	FY1981	FY1982	FY1983	FY1984	FY1985	FY1986	FY1986	FY1987	FY1987
	Actual	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Budget	Current Policy	President's Budget
Total Outlays	576.70	657.20	728.35	795.95	841.82	946.30	986.70	979.95	1022.85	994.00
Total Revenues	517.10	599.25	617.75	600.55	666.45	734.05	777.80	777.15	844.70	850.25
Defense and International Affairs*	145.15	166.65	194.20	218.30	239.40	269.35	286.70	283.15	300.20	301.85
Elderly/ Disabled	217.05	250.85	279.75	305.85	320.50	343.55	362.35	362.30	385.65	377.45
Net Interest	52.50	68.75	85.00	89.75	111.05	129.45	137.70	142.75	144.10	148.00
Non-Elderly Poor	40.75	46.20	46.25	52.45	55.45	57.65	59.70	59.35	62.80	56.95
Remaining Programs	121.25	124.75	123.15	129.60	115.42	146.30	140.25	132.40	130.10	109.75

* Export-Import funding is excluded in all years.

Defense Breakdown for 1985 and beyond	252.75	269.45	265.85	284.20	282.25
050	16.20	17.10	17.15	14.90	18.60
150	-0.40	-0.15	-0.15	-1.10	-1.00
Less Ex-Im	269.35	286.70	282.15	300.20	301.85

FUNDING FOR THE NON-ELDERLY POOR
Program Definitions Supplied by JEC Staff

(Outlays in Billions of Dollars)

	FY1980	FY1981	FY1982	FY1983	FY1984	FY1985	FY1986	FY1986	FY1987	FY1987
	Actual	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Budget	Current Policy	President's Budget
ENTITLEMENTS										
550 Medicaid (60%)	8.40	9.55	9.90	10.85	11.40	13.60	14.65	14.80	15.85	14.80
600 Food Stamps (91%)	8.30	10.25	10.00	11.50	11.40	11.40	11.50	11.40	11.90	11.25
600 AFDC	7.30	7.75	7.55	7.85	8.35	8.65	9.10	9.05	9.50	8.20
500 Foster Care/Adoption Assistanc	0.25	0.35	0.30	0.40	0.50	0.55	0.55	0.60	0.60	0.60
500 Social Services	2.70	2.65	2.55	2.50	2.80	2.75	2.60	2.60	2.70	2.70
600 Child Nutrition	4.20	3.45	3.00	3.30	3.55	3.65	3.90	3.90	4.15	3.50
SUBTOTAL	31.15	34.00	33.30	36.40	38.00	40.60	42.30	42.35	44.70	41.05
DISCRETIONARY PROGRAMS										
750 Legal Services	0.30	0.30	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.05
600 Low-Income Energy Assistance	1.60	1.80	1.70	2.00	2.05	2.15	2.00	2.00	1.95	2.10
600 WIC/CSFP	0.70	0.95	0.95	2.25	2.40	1.55	1.60	1.60	1.65	1.65
550 Maternal and Child Health Care	0.45	0.45	0.35	0.50	0.40	0.50	0.45	0.45	0.50	0.50
550 Community Health Centers	0.30	0.30	0.30	0.35	0.35	0.40	0.40	0.40	0.40	0.40
550 Indian Health Services	0.55	0.60	0.60	0.65	0.70	0.70	0.75	0.75	0.85	0.75
550 Migrant Health Services	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
600 Housing Assistance	5.65	7.75	8.75	10.00	11.25	11.40	11.85	11.45	12.40	10.40
SUBTOTAL	9.60	12.20	12.95	16.05	17.45	17.05	17.40	17.00	18.10	15.90
TOTAL	40.75	46.20	46.25	52.45	55.45	57.65	59.70	59.35	62.80	56.95

FUNDING FOR THE ELDERLY AND DISABLED
Program Definitions Supplied by JEC Staff
(Outlays in Billions of Dollars)

	FY1980	FY1981	FY1982	FY1983	FY1984	FY1985	FY1986	FY1986	FY1987	FY1987
	Actual	Actual	Actual	Actual	Actual	Actual	Current Policy	President's Budget	Current Policy	President's Budget
370 Elderly & Handicapped Housing	0.75	0.80	0.75	0.80	0.65	0.50	0.55	0.50	0.65	0.40
500 Older Americans	0.70	0.90	0.90	0.90	1.00	1.00	1.00	1.00	1.05	1.00
550 Medicaid (40%)	5.60	6.35	6.60	7.20	7.60	9.05	9.80	9.90	10.60	9.90
570 Social Security and Medicare	152.15	178.75	202.55	223.30	235.75	254.40	268.55	268.70	288.25	282.45
600 Railroad Retirement/Black Lung	6.60	5.45	5.55	5.60	5.45	5.60	5.60	5.35	5.70	5.45
600 Federal Employee Retirement	26.35	31.30	34.35	36.50	38.05	38.60	41.30	41.40	43.30	42.45
600 Food Stamps(9%)	0.80	1.00	1.00	1.15	1.10	1.15	1.15	1.15	1.15	1.10
600 Supplemental Security Income	6.40	6.45	6.85	7.90	7.65	9.60	10.20	10.15	10.40	10.50
700 Veterans Hospitals and Medical Care	6.00	6.95	7.50	8.25	8.85	9.55	9.95	9.85	10.15	9.70
700 Veterans Compensation and Pensions	11.70	12.90	13.70	14.25	14.40	14.10	14.25	14.30	14.40	14.50
TOTAL	217.05	250.85	279.75	305.85	320.50	343.55	362.35	362.30	385.65	377.45
Totals on Allocated Programs for 1985 and beyond										
Food Stamps						12.55	12.65	12.50	13.05	12.35
Medicaid						22.65	24.45	24.70	26.45	24.70
						1.13	1.14	1.13	1.17	1.11
Aggregations for 1985 and beyond										
Social Security						188.60	199.40	200.05	211.40	212.20
Medicare						65.80	69.15	68.65	76.85	70.25

APPENDIX TO GRAPHS B & C

(3)

PREPARED STATEMENT OF SENATOR JIM ABDNOR, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

It is a pleasure to present this statement before the Budget Committee.

Until recently the fiscal 1987 budget outlook seemed grim. Excessive Federal spending would result in a fiscal 1987 deficit approaching $200 billion. While even larger deficits loomed in following years. A Gramm-Rudman sequester order amounting to $50 or $60 billion could result this fall, devastating many programs. Moreover, serious consideration of a tax increase was gaining momentum.

One analysis even projected the effects a fiscal 1987 sequester would have on a State-by-State basis. Several newspaper accounts described how South Dakota would be devastated by its share of a $50 billion sequester order. Of course, this analysis assumed Congress would not act to avert sequestration.

Other reports argued that essential Government activities would be crippled by Gramm-Rudman. The Coast Guard and FBI would be practically dismantled. Our national defense would be devastated by deep budget cuts. The social safety net would be shredded. Horror stories abounded about the effects on the poor and homeless.

Earlier this month OMB and CBO both issued their estimates of budget outlays, receipts, and deficits through fiscal 1991. Instead of larger deficits as far as the eye could see, the deficits were projected to decline for the next five years. The fiscal 1991 deficit would end up at $104 billion.

The fiscal 1987 budget deficit is estimated at about $182 billion. To meet the Gramm-Rudman deficit ceiling of $144 billion, baseline outlays must be reduced by about $38 billion. Thus, if Congress can manage to trim baseline outlays by less than 4 percent, no sequestration would take place.

I am aware that a severe recession would make the budget outlook less encouraging. It's also a fact that CBO and OMB differ in a number of respects regarding projected defense spending and economic assumptions. We all recognize that economic forecasting is as much an art as a science. The budget picture could change as a result.

However, the current overall economic outlook is good, and seems to be getting better all the time. Recent employment gains have been strong, and the unemployment rate has fallen to its lowest level since March 1980. Interest rates are declining, the stock market is booming, and housing starts remain high. The administration's assumption of 3.4 percent real growth in 1987 (year over year) seems fairly reasonable.

A fairly optimistic economic forecast is justified by recent economic trends, especially the collapse of oil prices. This decline of oil prices, if sustained, should help restrain inflation. Lower inflation will tend to lower expenditure growth, and the drop in oil prices should save money in energy intensive sections of the budget such as defense.

The falling price of oil will provide an enormous stimulus to economic growth in America and abroad. If four percent real growth was a reasonable forecast before the oil price collapse, it may prove to be conservative now. A higher rate of economic growth would further pare the deficit and make Congress's job easier. An oil import fee would only dilute or even offset the beneficial effects in the United States.

In our search for budget savings, no program or expenditure should be exempted from the closest scrutiny. A healthier economy will make the job of budget control a bit easier than it would otherwise be. But as favorable as things look for the overall economy, agriculture remains in a deep depression. The safety net for rural Americans is already unraveling, and we must avoid making their plight even worse.

In conclusion, I'd like to note that a tax increase is not needed under Gramm-Rudman if Congress does its job. A tax increase only runs the risk of undermining the economic growth that has created over 9.5 million jobs in the last 3 years.

Thank you.

The CHAIRMAN. Thank you very much, Chairman Obey, for that very sharp, pointed testimony.

Let me begin with a few questions. Based on testimony at the hearings held by the Joint Economic Committee, what would you recommend is a reasonable projection of real GNP growth over the next several years?

Mr. OBEY. Well, I think it is—I guess the first question you have to ask yourself is are we—do we expect that we are going to be sig-

nificantly luckier the next 5 years than we were the previous 5 years. I think that we hope we will be.

I think the average consensus—or, I think, the consensus of private economists is that the administration for this year, thanks to the unexpected drop in oil prices, is probably closer to the growth in their estimates to what we will actually experience by way of economic growth than we thought previously.

Most people seem to think they are still overestimating growth by ½ to 1 percent. I am not sure who is right, but if we're in a normal year it would not matter. You could go with 4 percent. But if you go with 4 percent, and that is 1 percent overstated, as you know that causes chaos in terms of a second round of budget reductions that will be required under the Gramm-Rudman process. So, I think, we ought to err on the side of safety and assume a somewhat slower economic rate of growth, so that we do not have to wind up going through the motions twice in budget cutting.

It is tough enough to get it done once, we ought to do it right the first time.

In outyears, I think it is very unlikely that we are going to see the kind of uninterrupted growth the administration is talking about. I am not certain what the numbers ought to be, but certainly I think, you ought to reduce your expectations on outyear growth by at least 1 percent, probably more.

The CHAIRMAN. Assuming that the Gramm-Rudman targets are met, what impact would this large increase in fiscal restraint have on the economy since, as you well know, the biggest restraint will be in that first year, 1987? Has your committee looked at that issue and have any particular feeling about——

Mr. OBEY. We have taken testimony from people who have a variety of views on it. Let me simply say that I think the consensus would be that the economy can afford significant deficit reduction this year because of the drop in oil prices which will create a good deal of additional demand in the economy.

I personally think that reducing the deficit to the target of $144 billion which Gramm-Rudman lays out for this year is very achievable and we should at least aim at that number. It is the outyears that I have some question about.

The CHAIRMAN. Many people are saying with the drop in oil prices that we really should not be that worried about the deficit and there are those that are saying the drop in oil prices, controlling inflation, will spur a great economic growth. There are some that are even saying that it may be higher than the administration's projection of 4 percent and, therefore, that will close some of the gap in the deficit.

How do you feel about those who are saying this continued drop in oil prices will actually be helpful for deficit reduction and, therefore, we do not have to see it as the end of the world if we do not hit $144 billion?

Mr. OBEY. I do not think you can run budget policy as though you are the permanent national president of the optimist club. I think you have to be skeptical and assume that you are going to run into nasty accidents down the line because that is the way life is and that is the way the economy has been for as long as any of us have been on this Earth.

Obviously, we will have a better chance to now meet the economic growth targets that the administration laid out for us this year, but I doubt very much that that is something which can be sustained for a 5-year period of time, as the administration suggests.

The CHAIRMAN. Thank you, Chairman Obey, for your testimony.

The gentlewoman from Illinois, the ranking minority member, Mrs. Martin.

Mrs. MARTIN. It's always a pleasure to see the gentleman from Wisconsin.

Chairman Obey, just for the record, is there a listing of the other members of the Joint Committee?

Mr. OBEY. A listing? We have not provided a listing.

Mrs. MARTIN. I just thought that might be useful.

Do I understand that your presentation is—and I am trying to just get that from the reading—that all members of the committee have not necessarily agreed with all parts of it but you hope to accomplish that soon? Is that correct? Just so I'm clear.

Mr. OBEY. We have a statement by Senator Abdnor, which I believe sums up his view of the basic Republican consensus on the committee, which I have already submitted for the record.

And I think it is fair to say that my statement probably represents the consensus on the Democratic side, not necessarily unanimous, but certainly the vast majority of members on the Democratic side.

Mrs. MARTIN. So that is the——

Mr. OBEY. As you know, the committee is divided 10 and 10, and so there is no technical majority on the committee.

Mrs. MARTIN. It would be nice if there could be some agreement.

Mr. OBEY. In that respect, I do not think we are going to be different than any other committee in the Congress.

Mrs. MARTIN. But you have asked us to reach agreement and may I commend you for that request earlier, than later.

I am also glad to hear you talk about economic growth, because I think we can share some goals and I would just tell you—I do not know how we are going to do it, but I think that you would find across party and ideological lines on the committee, a growing recognition that earlier rather than later will be the route that can help every Member of Congress. And whatever one's individual philosophic beliefs, that that could fit within that. And it is going to be difficult to reach those compromises.

I would not agree that we should do it with revenues first, but there still has to be some intermingling or we are just all going to look like fools.

So I thank you for that request, because it is one that is falling on ears that agree and think leaders like you, that say that, will help both sides of the aisle. I am grateful.

Mr. OBEY. Thank you.

The CHAIRMAN. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, for your consistent testimony.

I am still trying to figure out how we get past this sequestering thing. As, I think, you pointed out—I do not know if you said it exactly—if we hit the sequestering, it is that same black part of

your chart again, the investment accounts, education. And then, of course, readiness and military.

I mean, that is what we get if we miss.

Now, what is our way, if we write a budget in here—and I think we are going to—that hits the $144 billion and then because it was impossible to predict these things accurately and using the most accurate numbers we have, we miss by $25 billion? And we get the first estimate of that on August 20.

What do we do then at that point? How do we really work this thing so that those education and maintenance programs and those readiness programs and military do not just get clobbered by sequestering?

Mr. OBEY. My honest view is that if we wait—if we assume the administration's economic assumptions, lock, stock, and barrel and play that optimistic game, and then we wind up missing by say, even only one-half a percent, it is very unlikely that we are going to come back at it and do a second operation. And you will get some kind of sequestration anyway.

I think we have to understand that what has happened in this place is that we have the authorization process, the appropriations process, then we layer it in the budget resolution. Now we have Gramm-Rudman on top of that. But we have not added any months to the calendar.

That means that we had better make sufficient reductions the first time around so that we do not run into the fact that Gramm-Rudman is flawed as an instrument of fiscal management because Gramm-Rudman requires you to go through that hoop twice, even if the only thing that has changed is the performance of the economy, rather than the will of the Congress or the President to meet deficit reduction targets.

Mr. LOWRY. Do you think we have any chance to change Gramm-Rudman to what you have been talking about ever since Gramm-Rudman came up, like structural deficits?

Mr. OBEY. I think long term we have to. As I said—and this is very complicated, I recognize that. But we have to look at why we are going through this business. We did not go through Gramm-Rudman because we decided that goose eggs looked beautiful on paper. We did it because we think that the deficits are so large that they are destroying the ability of the economy to grow as fast as it would grow under better fiscal management.

And, I think we have to make certain that the deficit reduction is enough to get down to manageable levels so we can reduce interest rates, et cetera, and get the economy moving faster than it has been.

By the same token, we do not want to permanently cripple demand in the economy by having deficit reduction that is so deep or so precipitous that the actual economic effect of Government fiscal policy is more constrictive than it ought to be until we reach full employment levels.

We can have legitimate arguments about what full employment levels ought to be, whether it is 4 or 5 or 6 percent, but—let me give you an example of why I think you ought to adjust it also for inflation.

When a family buys a house—let us say that you buy a house today. It is worth $50,000 and you take a $40,000 mortgage, it is a small house; 10 years later, inflation will have increased the value of that house so that it is probably worth $80,000 to $100,000. Your mortgage—let us say you have not paid off a dime of the principal. Your mortgage will still be at $40,000.

The $40,000 debt on an $80,000 or $100,000 house is a lot smaller real debt than the $40,000 debt on a $50,000 house. That's the way we manage our families.

We are told that we ought to manage our Federal budget the way we manage our families. I agree with that, provided that you carry through with the full logic of that statement.

Mr. LOWRY. I encourage you to continue on that way. We have got to make some changes.

A second thing. In my view, there are two things wrong with this budget. Middle and upper middle income retirees, Social Security, and Medicare. Regardless of how much you got you get it anyway. And the defense budget.

We just kid ourselves if we approach any other thing. I think we kid ourselves if we think there is a political solution that does not hit the fence hard and hit middle and upper middle income retirees.

What do we do about Social Security and Medicare and middle and upper middle income retirees?

Mr. OBEY. Well, frankly, what distresses me is that I think there is a politically cliched way that we go at this problem, and what it means is that when we go out in our districts, you see people talking as though, if you're 65 years of age plus 1 day, you're a sainted senior, and if you're 65 years of age minus 1 day, you're a welfare bum.

We need to treat the elderly poor and the nonelderly poor with the same fairness.

I don't know how you deal with it on the political side. It is a political, as opposed to economic, problem. The gentleman sitting next to you, I think in his budget package last year demonstrated a balanced way to go at the problem. And what I have told my seniors is, Look, you betcha, as long as the military budget is getting a 12-percent increase this year, I'm not going to touch any increases in your programs. But, by God, the day we get everything on the table—everything, including military, including revenue—you betcha, I'm going to ask you to do your fair share.

I may get somebody who stands up and says, Well, you know, that's not fair. We've earned it, et cetera, et cetera. My response to them is, Look, your generation was the generation that whipped the Depression, that won World War II. You've always been able to lead the country and willing to lead the country in making sacrifices. I don't really think you've changed that much.

And at that point, most people in the room agree. And I just think you have to take it head-on and ask for equal, shared sacrifice.

The CHAIRMAN. The gentleman from Minnesota, Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

I don't think I'll need to take all my time. I just want to follow up on the questioning about your advice to us on how to approach the budget. Your advice is an across-the-board freeze plus whatever revenues are necessary after that to make up the difference. Are you talking about a freeze in nominal or real terms?

Mr. OBEY. Let me amend your statement in this respect. I don't want to give this committee advice on how they ought to proceed. I'm simply talking about where we ought to wind up in the end. The timing is up to people with a lot more clout than I have around this town or building.

I personally would think that the best way to approach a freeze is in nominal terms, adjusting for demographic changes at most.

Mr. WEBER. OK. Do you have just off the top of your head how much additional revenues that leaves us to have to make up?

Mr. OBEY. I'm not really certain. I've heard the chairman of this committee at one point suggest maybe it's $12 or $14 billion. I'm not certain.

Mr. WEBER. Is that a consensus view of your committee or of the Democrat side of your committee, or is that just your personal view?

Mr. OBEY. In this respect, I am giving you my personal views. I don't want to speak for anybody else or put them in a basket without—I personally believe that it represents the views of most of the Democrats on my committee, but I don't want to assert that. I'd rather have each of them speak for themselves, as I'm sure they will, when we issue our economic report.

Mr. WEBER. I think I understood your answer to Mr. Lowry, but let me just make sure. Let me make it explicit, to make sure I understand.

You are saying that if we enact a nominal freeze on the budget, including a nominal freeze on defense spending, that you think then part of that package—your recommendation would be that part of that package would also be a freeze on Social Security?

Mr. OBEY. What I am saying is that I would not touch Social Security as long as anything else is off the table, and no one is talking about reductions in Social Security. What people are talking about is whether or not a portion of a COLA might be limited, if everybody else is being squeezed, including Cap Weinberger's programs. What you're talking about is whether you might go the other route and change the threshold at which income is taxed for retirees, bringing that down slightly.

There are a number of ways you can do it, but I would pick up some savings from all programs around the horn.

Mr. WEBER. That's not quite the same, though, respectfully, as a freeze on absolutely everything.

Mr. OBEY. Whether you are dealing with it on the revenue side of the retirement equation or whether you're dealing with it on the COLA side of the equation, the net effect to the budget is the same in terms that you can achieve a nominal dollar effect on the deficit, no matter which way you approach it.

Mr. WEBER. So that you would say that as part of that freeze, we should get the dollar out of Social Security that we would get if we froze COLA's for 1 year, even if we didn't get them by freezing COLA's for 1 year?

Mr. OBEY. I would agree to that only if you had the Pentagon on the table for exactly the same kind of cuts, and if you had every other program on the table, including revenues for other people.

Mr. WEBER. OK. I understood you until the last sentence there. What do you mean, "including revenues for other people?"

Mr. OBEY. If you're looking at changing the levels at which you kicked in taxation on income for retirees, I think you should be looking at other sources of revenue as well, not just revenue from senior citizens.

Mr. WEBER. So that the magnitude of the tax——

Mr. OBEY. In other words, corporations and individuals who aren't paying a dime ought to be paying their fair share, and that revenue, for the moment I think, ought to be used for deficit reduction, rather than further rate reduction.

Mr. WEBER. I understand that. Is your idea that you've just described in terms of taxes, is that the way that you would get to the $12 to $14 billion you've talked about, or is that in addition to the $12 to $14 billion?

I'm not saying that's your number, but let's use that for a minute, because the number that exists there, that needs to be made up in revenues if we do what you want to do in terms of freezing the rest of the budget, when you discuss taxes, as you just have, are you discussing how to get to that number or something additional?

Mr. OBEY. I guess I don't understand the gentleman's question.

Mr. WEBER. OK. Well, you've just described—I'm trying to understand exactly what you're suggesting would be the best approach to the budget.

You're talking about a freeze across the board on everything and potentially a $12 to $14 billion tax increase being necessary to meet Gramm-Rudman's targets, because the freeze won't necessarily get us there.

My question to you is, I'm trying to get at what do we do with Social Security, which is one of the two big, thorny points we have.

Mr. OBEY. That's not up to me to decide. As I've said, there are a variety of ways you can do it. My job is not to tell the Ways and Means Committee, or the Budget Committee, or the Appropriations Committee how to get every jot and tittle of the problem dealt with. My job is simply to suggest where I believe we ought to wind up in macroeconomic numbers.

Mr. WEBER. I understand, Mr. Chairman. But you brought this up to us, and I'm not trying to—I'm just trying to clarify in my own mind what it is you have suggested to us.

Mr. OBEY. I am not suggesting anything. What I am saying is that I, personally, will be willing to vote for almost any combination of events around here to get the deficit under control, and I'm not going to object to tiny details if an alternative does not happen to be a pluperfect way of approaching it the way I would approach it.

There are a number of ways. As you know, we can approach it on the Social Security side, on the welfare side, on the domestic entitlements side, you name it.

I urge you to remember what Rudy Penner said in his testimony recently. He laid out that on the domestic discretionary portion of

the budget, that in 1958—I mean in 1980, that portion of the budget took up approximately 5.8 percent of GNP, that it is down today to about 4.1 percent of GNP, which means that as a percentage of GNP, we are now devoting less to domestic discretionary programs than we were before the Great Society programs began in 1964. And even if we do not pass the President's budget, domestic discretionary programs will be down to 3.7 percent of GNP by 1991, and the President wants to take it below that to 2.7 percent and I am saying, that is not a fair way to share the burden.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Thank you, Mr. Chairman.

I want to apologize to my dear friend from Wisconsin that I wasn't here for the beginning of his testimony, because I have great respect for his intellect and the dogged determination with which he has been trying to bring the various elements of the Congress and administration together to solve this problem.

I know from little, short visits that we've had an opportunity to have since Congress came back in January that you share some of the frustration that I do. When we left here in December, we were led to believe by all of the assumers that by doing nothing, the deficits would go in excess of $300 billion by 1991. Further, that we were probably looking at a projected deficit for fiscal year 1987 in excess of $200 billion. Then, lo and behold, we get back, and all of a sudden the budget is going to balance itself if we don't do anything, and, praise the Lord, we're only looking for $37 billion instead of $60 billion or so.

I find this a little bit difficult to swallow, and I share my friends concern about that. I just want to share a few figures with him that perhaps he's already gone through. But I got to playing with some figures over the weekend, as these things floated around in my mind, and discovered, at least for me, some very interesting things. We don't talk about these things very much, but I think they are absolutely key to the solution.

I went back and took the revenue estimates in Jimmy Carter's four budgets, for example, and on an actual basis for the budgets that Jimmy Carter was responsible for—1978 through 1981—and found out that we had collected about $43 or $44 billion more in revenues than the Carter budgets projected as revenues on a year-to-year budget. If you took Carter's 5-year projection at the beginning of his Presidency, that was down a little bit, but not a whole lot.

Compare that to the first 4 years of this President. We collected over the first 4 years of the Reagan Presidency, the budgets that he was responsible for—fiscal 1982 through 1985—was around $169 billion short. In other words, in that collective 4-year period, on an actual basis versus a year-to-year projection basis, we had come up consistently short. We had only 1 year where we collected more revenues; I think it was 1983 or 1984, than had been projected. And on the 5-year projection that this administration issued when it first came into office, the difference was like $369 or $370 billion.

My point in saying that is that I don't see how we can approach this budget cycle—and I'd like for my friend to comment on this when I finally make the point—how we can content ourselves to

say, Well, we're only going to do this $37 billion, and that's going to be real easy to get, and we're going to all go home and brag about the fact that we met Gramm-Rudman. After the historical facts of at least the last 4 years, I don't believe that's going to be the way it's going to be.

So my point is that when we do, in fact, get around the table and solve this problem, we need to build into that solution enough insurance to make sure that we don't wind up, when the picture is taken in the future, and say uh-oh, we missed revenues by 6 percent again. We're really going to collect about $16 or $18 billion less than was projected in this budget, than we thought we were, and so forth and so on, or the unemployment rate has not gone down quite as much.

What would the chairman think about that idea? In other words, if we're going to attempt to sit down on a bipartisan basis and hopefully solve this problem this year, shouldn't we build ourselves in a little insurance into that solution?

I do not at all disagree with the gentleman's basic formula, as he knows. I think that any real solution to this problem has to include some additional revenues.

But what's your thought on whether or not we should build $10, $15 billion, say, into our budget this year for contingencies, so to speak?

Mr. OBEY. Well, I think—I don't know what the number ought to be. This committee is more qualified to determine that than I am. But I do think that we need to have a certain degree of safety, a certain safety margin, because otherwise we will wind up having to do a second round within a very short period of time. And my guess would be, if we try to do a second round, that what would happen on the continuing resolution is that in the end, because of the election that faces us in October, I think probably the White House and the Congress itself would wind up delaying those actions until, say, March of the next year.

On revenue, I think it's interesting to note that when Treasury Secretary Baker testified before the JEC last Thursday, he indicated in his statement that we needed to protect the President's military buildup, we needed to protect Social Security, we needed to protect entitlements in the social safety net.

I pointed out to him that I assume that if he—that since he said we needed to protect all of those programs, such as Social Security and Medicare, et cetera, that the administration also supported the revenues that pay for those programs. And he said, of course, that that was right.

Then when I pointed out to him, as demonstrated on this chart, if you take a look—since for the moment all of the parties seem to be supporting the revenues for Social Security and Medicare—at the general purpose revenue items in the budget—if you take a look at the percentage of GNP which has been collected in general purpose revenues, using the same timeframe that the administration uses, because the Treasury Secretary always likes to go back to 1964, if you do that, you see that as a percentage of GNP, general purpose revenues have declined from slightly over 14 percent of GNP in 1964 to around 12 percent of GNP this year. So there is a significant gap there.

What we simply have to start telling the American people is it is a nice deal if you can get a dollar's worth of program and service for every 79 cents you pay in taxes but long term that bends the economy out of shape and raises the cost of mortgages and other things which their kids are going to have to pay.

Mr. LEATH. I thank the gentleman.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Thank you, Mr. Chairman.

The CHAIRMAN. I want to acknowledge that I know that we have Chairman de la Garza waiting and Congressman Moody. This is our last question.

Mr. SLATTERY. Mr. Chairman, I will be very brief.

First of all, I would like to commend the chairman for being here today. I personally appreciate the leadership, Mr. Obey, you have demonstrated in the past on the deficit issue and the tenacity that you have approached this issue with. I think you should really be commended for that.

I would like to follow up if I could for just a second with what my colleague from Texas was questioning you about, specifically the concept of having some kind of standby tax authority to meet the revenue projections of the administration.

In other words, if the Congress can meet the spending levels required to get to the $144 billion target of Gramm-Rudman, what would be wrong with building into the system some assurance that in the event that the growth projections that the President is relying upon to prepare his budget, do in fact not materialize, what would be wrong with building into the system some kind of standby tax authority so that we can hit the revenue target? Has your committee given any thought to that?

Mr. OBEY. I think that's a somewhat different question than I thought I was addressing when I was responding to Mr. Leath's question.

Mr. SLATTERY. It is a different question. It is a followup on his line of reasoning.

Mr. OBEY. I have personally favored for years—and this was something which was proposed by my predecessor in my district, Mel Laird—I personally favored for years giving the administration the authority to raise or lower, within a very narrow band of limits, tax rates. I favor that institutionally as a management tool. I do not favor providing—this is the first time it has been suggested to me and I will certainly roll it around in my head—I would not favor the idea of doing a standby tax in the context of Gramm-Rudman. Up front and clean and I think we need a three-legged stool to begin with. I personally do not believe that the President will ever agree to the kind of military spending reductions that would be necessary from his budget in order to reach Gramm-Rudman goals solely on the spending side. I believe that there ought to be up front and around the horn a three-legged agreement including revenues.

Mr. SLATTERY. It just seems to me that we are in a situation where we have two major variables to deal with. One is being able to hit the spending levels prescribed in the budget resolution. Assuming we are able to achieve that level of spending. The other

side of the equation of course is achieving the revenue projections that we are all relying upon.

It seems to me that at some point in time it might make some sense to build into the system some provision that in the event the spending reductions are achieved, but the revenue base does not grow as fast as projected, that we may need some kind of standby authority to implement perhaps an oil import fee, and in addition to that, some kind of change in the cigarette tax or minimum corporate tax, something like that, to achieve the kind of revenue base that we are all projecting.

Mr. OBEY. I guess what I would prefer to do is to simply say that we ought to try as much as possible to get to an outlay freeze across the board and for any items for which you cannot reach that level, anyone who wants to bear the burden of supporting an increased spending level above that outlay freeze, would have to bear the burden for wanting a revenue increase to pay for that spending above the freeze level.

Mr. SLATTERY. I have no further questions.

The CHAIRMAN. Thank you, Chairman Obey, for your testimony and your leadership.

The chairman now calls Congressman de la Garza, the chairman of the Agriculture Committee of the House of Representatives.

All the members are being given a list of witnesses who will be testifying and the time constraints. They are very tight. We want to give an opportunity to all Members who have requested to testify before the committee.

Chairman de la Garza, we welcome you. We are sorry that we are running about 10 minutes behind schedule. Your full testimony will be submitted for the record. Feel free to summarize your views with regard to the President's budget as well as the area to which you are the expert, agriculture. Welcome, Chairman de la Garza, of the Agriculture Committee of the House of Representatives.

STATEMENT OF HON. E. (KIKA) DE LA GARZA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS AND CHAIRMAN, AGRICULTURE COMMITTEE

Mr. DE LA GARZA. Thank you very much, Mr. Chairman. Let me thank you on behalf of our committee for your kindness, generosity and patience to us and also to commend you and your committee for the great work you have done.

Mr. Chairman, I have a letter which I will read and that is the extent of my testimony. It will be very brief.

In complying with section 301 of the Congressional Budget Act of 1974, I am submitting to you the recommendations of the Committee on Agriculture with respect to the fiscal year 1987 budget for the agencies and programs under its jurisdiction.

At this time, the Committee on Agriculture would support a continuation in 1987 of budget authority at the fiscal year 1986 levels for all program funding provided in appropriation bills, expenditures of the Commodity Credit Corporation, Federal Crop Insurance Corporation, and Farmers Home Administration, are recommended at levels consistent with the provisions of the Food Security Act. That's the farm bill.

The Agriculture Committee recognizes the need to reduce Federal budget deficits and will cooperate with the Budget Committee to achieve the 1987 target deficit of $144 billion. The Agriculture Committee is the only committee to have its reconciliation savings for fiscal year 1986 enacted. The remaining savings of 1986 reconciliation legislation are still the subject of conference with the Senate and negotiations with the administration.

It is unclear exactly how much spending will need to be reduced to reach the 1987 target deficit. Therefore, we cannot recommend specific reductions at this time nor can we endorse any of the proposed reductions contained in the President's budget submission.

Indeed, continuing economic stress may require increases in some programs. We cannot propose user fees without sufficient evidence concerning the effect on specific industries and analysis of who would bear the cost of such fees and consideration of who are the beneficiaries of Government services for which fees would be collected.

The Committee on Agriculture urges the Budget Committee to consider the difficulties besetting the farm economy and to remember that during the conference on the Food Security Act, $11.2 billion in spending reductions over the fiscal years 1986 through 1988 period remain well beyond the $7.9 billion required.

That is the letter which we are submitting on behalf of the Agriculture Committee, which earlier today voted unanimously that we send this letter to you, Mr. Chairman.

[The letter referred to above follows:]

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, DC, February 25, 1986.

Hon. WILLIAM H. GRAY III,
Chairman, House Committee on the Budget, Washington, DC.

DEAR MR. CHAIRMAN: In compliance with section 301 of the Congressional Budget Act of 1974, I am transmitting to you the recommendations of the Committee on Agriculture with respect to the fiscal year 1987 budget for the agencies and programs under its jurisdiction.

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The Committee on Agriculture urges the Budget Committee to consider the difficulties besetting the farm economy and to remember that during the conference on the Food Security Act, $11.2 billion in spending reductions over the fiscal year 1986 through 1988 period were made, well beyond the $7.9 billion required.

With warm regards, I am
Sincerely,

E (KIKA) DE LA GARZA,
Chairman.

The CHAIRMAN. Thank you very much, Chairman de la Garza. I want to thank you for the cooperation you and your committee have given to the Budget Committee. Last year we did achieve cuts of over $50 billion in spending and the Agriculture Committee was extremely helpful in that respect.

At this time, Chairman de la Garza, the deficits are even larger than anyone estimated they were and therefore there are going to have to be reductions again. Does your committee have any particular places that if they had to make reductions now, they could examine to find such reductions?

Mr. DE LA GARZA. We have the staff working on that, Mr. Chairman. There is no specific area that I would submit to you at this point, only our insistence that we will cooperate with you and if it is fair and if it is equitable and if everyone does his share, so shall we.

The CHAIRMAN. Thank you very much, Chairman de la Garza. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. I would yield to the gentleman, Mr. Slattery.

Mr. SLATTERY. One very brief question of the chairman. According to some of the CBO baseline projections, the cost of various commodity programs is projected to decline in 1987 by some $6 billion by some of the conservative estimates. I have seen estimates even higher than that in terms of what it is projected to decline. Mr. Chairman, do you think that is going to happen?

Mr. DE LA GARZA. It is a very difficult one but right now I would not eagerly anticipate any reduction in cost of programs at this point.

Mr. SLATTERY. The reason I asked the question is that this morning the majority leader of the Senate on "Good Morning America" indicated it looked like to him that the cost of the farm programs in the second Reagan term was going to be in the neighborhood of $100 billion. That does not jive with the figures we were looking at as recently as several months ago when we voted on the last farm bill.

Mr. DE LA GARZA. He said the cost would be?

Mr. SLATTERY. The cost of farm programs during the last Reagan term, the term we are in right now, would be some $100 billion. That is what he was saying on "Good Morning America." I would observe those numbers do not jive with the numbers we were looking at when we all voted on the farm bill several months ago.

Mr. DE LA GARZA. I would not agree with those numbers. I do not anticipate reduction at the present time. This was our understanding and this was projected in the legislation but $100 billion—there is much confusion. The average person assumes that to be in 1 year when we are dealing with a 5-year program. I do not think so. I do not think the program cost—as a matter of fact, I think they would be fairly close to the projected $50 to $52 billion, unless everything just goes down the drain.

As a matter of fact, the cost of the program—this is one of the difficult areas—the cost of the program would be far less than the

cost to other programs with farmers dropping by the wayside and people having to go on welfare rolls and food stamps. Besides the human suffering, that would be much more than any increase in the cost of the program. Those are limited to not too terribly many people.

The CHAIRMAN. The gentleman from Texas, Mr. Leath.

Mr. LEATH. I just want to thank my good friend and colleague for his testimony. I know from past experience that he will do his share and his committee will. We appreciate your testimony.

The CHAIRMAN. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you, Mr. Chairman.

Chairman de la Garza, I just want to clarify something. You are telling me your committee voted unanimously to send you here with the arguments you have made. I gather that says they are against the 20 percent cut in USDA operations outside of the farm support programs, they oppose the 57 percent cut in the agriculture extension programs and the 40 percent cut in the short term and intermediate term export guarantees and all of the programs that are important to bringing agriculture back in terms of foreign trade. Is that encompassed in your letter to us?

Mr. DE LA GARZA. No, sir; that is not a correct interpretation. What we say is we don't know where we are. We don't know the extent of savings we have to contribute. There are very few members happy with the budget proposed by the administration. There are very few members happy with the meat ax approach of Gramm-Rudman. All we are saying is when you tell us how much, give us the leeway, we will use the scalpel and we will make the reductions and we will set the priorities.

Mr. FAZIO. I want to join with my colleagues in indicating that I am confident you would do it right if we gave you that responsibility, which we should.

Are there any members of your committee who support the President's agricultural budget submission?

Mr. DE LA GARZA. I know of no one and no one has told me that he supports the President's budget. I would assume there is no one on our committee who 100 percent supports the President's budget.

Mr. FAZIO. I understand that Phil Gramm is, even publicly, against the cuts in agriculture extensions. I would not be surprised that it would not be unanimous in Congress. I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Chairman de la Garza. We look forward to working with you as we again try to tackle the problem of deficit reduction.

Mr. DE LA GARZA. Thank you.

The CHAIRMAN. At this time, the Chair calls to the witness table the chairman of the Rules Committee of the House, the distinguished gentleman from Florida, Chairman Claude Pepper. Chairman Pepper, we welcome you to the Budget Committee to briefly share your views on the President's budget and the task of deficit reduction.

You have been an eloquent spokesman for the least of these in our society, particularly the elderly and those who have built our Nation.

We have welcomed you. Your testimony in its entirety will be submitted for the record. Feel free, Chairman Pepper, to summarize your views and to share your principal concerns. Thank you for coming.

STATEMENT OF HON. CLAUDE PEPPER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA AND CHAIRMAN, RULES COMMITTEE

Mr. PEPPER. Thank you very much, Mr. Chairman and members of your distinguished committee. I am very pleased to be here today to convey to you some of the impressions I have received in returning to my district where I was this weekend.

Yesterday afternoon I met with the chamber of commerce, the mayor and the members of the city commission of the city of Miami Beach. They had invited me to this meeting to tell me all the things they were trying to do to help the people of that city who were being impaired by the cuts that were being made by the Gramm-Rudman bill. They were pointing out that it was going to be very severe to their people. They enumerated all the various areas where these cuts were to be impacting their community.

At an earlier time I was at a meeting of senior citizens. They were bemoaning what was going to happen to them. A lady who runs the meals program, which I take some pride in because I was the original author of that legislation, they were telling me that out of 11 meal programs they had, 3 were going to be cut out by the Gramm-Rudman bill. The elderly were complaining about housing and the like.

I have dealt with the various areas here in my statement which I will submit for the record, Mr. Chairman. I have dealt with the cuts proposed by the President including deferrals and rescissions.

I want to read a letter, Mr. Chairman, that I think is very indicative. It is addressed to me.

> It has been brought to our attention that the Adult Day Care Program is going to be affected or eliminated if it does not receive the necessary funds. Our grandmother, Thelma Bednarkiewicz, depends on the services of this program in order to make living more meaningful. The program also allows us to go to school and to work each day knowing that our grandmother is receiving excellent care at the Center. Our grandmother can't be left alone all day because she has had two strokes which has left her paralyzed on the right side. There is no doubt that if these services are discontinued, our grandmother will have to be admitted to a home for the aged.
>
> Government is quick to cut corners at the expense of our young's education and our old's care after their usefulness has diminished. We must all remember that we will be getting old some day and possibly unable to take care of ourselves. We need the security of not having to live our later years with no help and possibly having to be institutionalized when, with a little help it is not necessary. Please consider that when we help the aged, we help ourselves.

I thought this was an interesting impression of a young person, that person's concerns about the plight of the elderly.

Mr. Chairman, I hope that the remonstrance from the country is going to be so severe—and if what I've seen at home is indicative of the country, I think it will—that will justify Congress in either partially or wholly repealing the Gramm-Rudman Act shortly after—I'd like to see it even before March 1—but shortly after the full impact of this nefarious measure is felt by the people of the country.

I would add only this, Mr. Chairman. I have never felt that the President had the right under the Constitution, properly interpreted, to hold up the expenditure of funds that are appropriated by the Congress, either by rescission or deferral. We know that by rescission, the Budget Act wisely provided that Congress has 45 days in which to approve the rescission. If we don't approve the rescission in 45 days, according to that provision, then it does not take effect.

But the law is ambiguous. Now that the *Chadha* case has come along and made it very uncertain whether the veto of either one or both Houses of the Congress can have any effect in deterring the deferral, I want to advise that it is the intention of our Rules Committee at a very early date to have hearings, since we have jurisdiction over the budget process, to have hearings on what we should do with respect to deferral power which is being asserted by the President.

I feel that the President should not defer any appropriation unless Congress authorizes a deferral. If Congress says this money is to be expended by a certain time, the Constitution says the President shall take care that the laws be faithfully executed. And I think when Congress makes a law, it is the duty of the President to execute it as provided in our Constitution.

But I am hoping that maybe if there's any ambiguity in what the law now is, or whether there is a necessity for any new provisions relative to the deferral power exercised by the President, we are hoping that our committee at an early date may offer clarity on that matter for the benefit of the Congress, and we hope to be able to have hearings upon that subject to which your distinguished committee will, of course, be invited, and we would hope that you would be able to attend.

So, Mr. Chairman, I am pleased to be here with you. Thank you for the privilege of expressing my views. This critical impact of this legislation and the President's rescissions and deferrals, I think, are contrary to the authority of the Congress to exercise its legislative power, and I believe that the angry remonstrance of the country is going to be coming to this Congress pretty soon, that will justify, if not require, that we repeal either all or major parts of the Gramm-Rudman legislation.

Thank you very much, Mr. Chairman.

[Testimony resumes on p. 630.]

[The prepared statement of Mr. Pepper follows:]

Prepared Statement of Hon. Claude Pepper

Thank you for the opportunity to testify. As Chairman of the Rules Committee, I was asked to discuss the effects of the President's budget on matters within my committee's jurisdiction. The task for your committee, putting together a budget resolution for fiscal year 1987, will be difficult. But while you are working on the coming fiscal year, we hope you will not forget the current year.

There is a pattern of abuse in the President's impoundment message for FY 1986. He is proposing $22.85 billion in deferrals, the second largest package of deferrals since the Impoundment Control Act of 1974. Some of the deferrals appear to be improper. Other deferrals are political acts aimed at winning battles the President lost in the normal legislative process.

- The President deferred the total $75 million payment to the Special Facility for Sub-Saharan Africa until January 17. The FY 1986 continuing resolution provided that funds "shall be paid...no later than December 31, 1985." By ignoring the proviso in the legislation and withholding the funds until after OMB and CBO took their snapshot for sequestration, the President insured that $3.23 million in budget authority will be permanently cancelled March 1. Congress clearly intended the full $75 million to be paid and the President had opposed the payment throughout the legislative process.

As you know, the deferral power may be constitutionally infirm. In the Impoundment Control Act, Congress balanced the President's power to defer against either House's power to veto. Since Chadha, however, any single-House veto is questionable. It appears the President wants to take advantage of the situation, exploiting the deferral power. The Rules Committee, one of the committees with jurisdiction over the Impoundment Control Act, will give serious attention to these matters.

The President's proposals for education and housing are obvious examples of the use of impoundment to undermine these programs and implement the President's priorities. This administration has attacked education and housing since it came to power. November 25 and December 12 of last year, the President signed the FY 1986 appropriation bills funding these programs. Immediately he set about to impound.

EDUCATION

The President is impounding $1.25 billion dollars from Department of Education programs. Some of the major programs to be affected are:

Student financial assistance

The President wants to rescind $456.4 million from student aid grants, loans and work study programs in FY 1986. This would mean:

- 193,000 fewer direct student loans,
- 291,000 fewer State incentive grants,
- 240,000 fewer supplemental grants, and
- 85,000 fewer work study awards.

The President proposes an additional 23% reduction for FY 1987.

Compensatory education for the dissdvantaged (Chapter 1 funding)

The Administration wants to eliminate the High School Equivalency and College Assistance Migrant programs. The President is proposing a voucher program to replace educational services to the disadvantaged.

Office of Bilingual Education and Minority Languages

The President wants to eliminate the Emergency Immigrant Education program. His budget for FY 1987 proposes no new budget authority for the program. For the remainder of FY 1986, the President wants to rescind $28.7 million. Funding for FY 1986 will be cut an additional $2 million under Gramm-Rudman.

Vocational and adult education

For FY 1987, the President proposes a 47% reduction in budget authority. For FY 1986, Gramm-Rudman will cut $35.6 million and the President wants to rescind $210 million. That is more than a 20% reduction in funding to be absorbed in the last half of FY 86.

Rehabilitation services

This program provides vocational rehabilitation state grants, funding for the Helen Keller Center and independent living centers. Gramm-Rudman will cut about $51 million and the President proposes to rescind an additional $75 million for about a 10% reduction in total funding for the last half of the current fiscal year.

Higher Education Programs

This account includes veterans' cost-of-instruction grants, aid to developing institutions, and the Center for Excellence in Education. The President proposed rescinding $180.9 million on top of $12.3 million in Gramm-Rudman cuts; about 40% of total FY 1986 resources are proposed to be cut. For FY 1987, the President proposed a 45% reduction in budget authority.

Libraries

Public library systems receive federal funds through project grant awards and grants to states. The President proposed rescinding $33 million, or about 25% of total funds, for the remainder of FY 1986. This will eliminate 210 public library construction projects and 192 literacy projects in public libraries. For FY 1987, the President proposed eliminating the program entirely.

HOUSING

In his FY 1987 budget, the President proposed to eliminate federal involvement in the construction and financing of subsidized housing.

- The President proposed a housing voucher program to replace section 202 housing for the elderly or handicapped loans, HUD subsidized housing loans, and USDA rural housing loans.

- The President proposed no new budget authority for the section 312 rehabilitation loan fund and grants, and rental development grants.

The President also proposed rescinding about $4.7 billion and deferring an additional $8.5 billion in FY 1986 housing programs. The programs include:

Annual contributions for assisted housing

This account funds section 8 lower-income housing, rental housing development grants (HODAG) and rental rehabilitation grants. The President proposed rescinding $4.4 billion and deferring (withholding the obligation) of any other available resources. Of the $7.03 billion deferred, the President proposes reappropriating $2.3 billion to finance the FY 1987 housing programs.

Urban development action grants

The President proposes rescinding $220 million of $330 million in new budget authority for grants to cities in distress. This account is also the subject of a deferral proposal.

Community development action grants

The President proposed deferring $500 million from grants to states and local governments for community development. The grants are used to provide housing and expand economic opportunities for people of low- and moderate-income.

Housing for the elderly and handicapped

The President proposed to withhold more than half the available resources for this program ($599.8 million of $1.16 billion) in FY 1986. This program provides direct loans to nonprofits to build and manage housing projects for the elderly or handicapped.

Congregate services

This was intended as a demonstration project to test whether contracting with local public housing agencies for meal service and other essential support services would be effective. The Administration proposes rescinding $2.55 million (of $2.67 million new budget authority) becuase no further demonstration funds are needed. However, the Administration says "the results of the demonstration were inconclusive."

Housing counseling assistance

The President proposes rescinding all available funds ($3.3 million) for comprehensive housing counceling services to eligible homeowners and tenants.

The CHAIRMAN. Thank you very much, Chairman Pepper.

For questions, the gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman, for again that excellent testimony. And I am really glad to hear and want to encourage what your committee will be doing on the question of deferral, which I think clearly is an illegal impoundment.

In essence, what the deferrals are, the President is assuming that his budget, as submitted for 1987, will be totally adopted. And the community development block grant, he's assuming the $2.1 billion and elimination of the 202 housing and on down the line.

So, I compliment you very much for—we have to get to an answer on this deferral. I think it's clearly an illegal impoundment.

Mr. PEPPER. Thank you very much.

The CHAIRMAN. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Mr. Chairman, thank you. It's always a pleasure to hear your feelings, and we appreciate your testimony.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Very briefly, I'm wondering if the chairman—and again, I join with my colleagues, Mr. Chairman, in welcoming you to the committee—I'm wondering, Mr. Chairman, if there is any way that you could support some of the suggestions that have been made here on the Hill to change the method of taxing Social Security by perhaps lowering the threshold?

There have been some people talking about this. The theory, of course, is that there are some senior citizens who are, of course, getting COLA's in their Social Security that perhaps don't need them, because they happen to be in higher income brackets. And some people believe and suggestions have been made that we

should include more Social Security benefits in taxable income for those in the higher income brackets.

I know we started doing this in 1983, but there have been suggestions that perhaps we should go further in taxing Social Security benefits. Is there any way that the gentleman could support any changes like that?

Mr. PEPPER. I would say to my good friend that I cannot bring myself to agree to anything that would impair either the character of Social Security as a social insurance program or that would subject more of its benefits to taxation or that would in any way impair the functioning of the organization as it is.

I know there is a strong feeling, and I'm concerned about it. It's a grave danger and I think a grave threat to the Social Security Program, that some people seem to get the idea that Social Security should be a welfare program. It isn't a welfare program. It's a social insurance program. And people who are not desperately in need are eligible for participation in that program. But it's the best thing that's ever been devised in this country that I know about or any other country to protect the retired people.

Now a lot of people during the years when they are paying into it and are affluent find themselves at the end of their lives very much dependent upon Social Security. I know of a case in Miami. There was a dentist whose daughter was very prominent in social affairs and all that, and the family was a very important family. You never would have thought that that family would have ever had any economic need. But one of my friends heard that gentleman—he died not long ago, in bad health—say he was looking forward to the time when he got his Social Security because he needed it. His father had had misfortune in business affairs, financial matters. He had trouble. And the result was, here was this affluent man, that was a social leader and all that, saying he was waiting with great interest and great joy for the receipt of his Social Security check.

So, you can't be sure when you're paying in what your situation may be when you're 65 years of age, you know.

Anyway, I think we ought not to tax Social Security. My goodness alive, the concessions that Government has given to some of the big business interests in this country are shocking compared to the little concession of having a relatively few people that should maybe pay income tax on their Social Security benefits. The amount is still relatively small, and so I don't think that we ought to—I'm in favor of repealing the tax that's already been imposed on Social Security and not doing anything to diminish the benefits of the system.

Now there are some needs, elderly women and some others that are not properly covered, because they were low-income receivers when they were paying in. They don't get much back. If you want to improve the benefits that Social Security bestows, I will support that, but I don't want to see any benefits reduced.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Chairman Pepper, I just want to thank you for being with us today and to particularly indicate my agreement with your

point on the administration's abuse of the rescission and deferral process.

I want to point out, this afternoon when the GAO is before Appropriations for their budget, we're going to ask them to take a much more aggressive role, one they have under law, of making choices between the categorization of these programs. The administration has been using deferrals, when they should have used rescissions, to weaken the hand of Congress, and we're going to make sure that the GAO begins to intervene to make distinctions between the type of approach that should be used, and I know you will benefit and the people you care about will, if we can get them to take that more aggressive stand.

Mr. PEPPER. Thank you very much. I'm pleased to hear that.

The CHAIRMAN. The gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Chairman, it's a pleasure to welcome you to my other committee. I enjoy serving with you as a part of the Rules Committee.

Mr. PEPPER. We are very proud of Mr. Frost, being a distinguished member of the Rules Committee.

Mr. FROST. And, Mr. Chairman, I really want to ask you briefly a couple of questions about the Rules Committee and the budget resolution this year.

It is possible that the Budget Committee will be coming to the Rules Committee twice, perhaps once in the next week or two, to send the President's budget to the floor for a vote, and then perhaps later on with another budget resolution, assuming the President's budget is not passed by the House.

And I would hope, as one Member who serves on both committees, that the Rules Committee would look to the chairman of our committee, the Budget Committee, for guidance, because the rules may be somewhat complicated this year in terms of what the committee will be seeking. And I would hope that our committee, our Rules Committee, would not make any prejudgments about the type rule, because it's going to be a complicated package this year, and it may be that the Budget Committee will be seeking a closed rule at some point or a highly structured rule, and I would hope that the Rules Committee would give the Budget Committee a great deal of latitude this year, because it's a very complicated situation.

Mr. PEPPER. I have said to my distinguished colleague that it is my purpose to call the matter to the attention of the Democratic caucus of the Rules Committee when we meet Wednesday to see what the pleasure of the committee may be, and of course we will look forward to the counsel of our distinguished colleague when we do that.

The CHAIRMAN. Chairman Pepper, we want to thank you for coming and testifying before us. Also, thank you for sharing your views on the budget for 1987 and the budget process.

Mr. PEPPER. Well, thank you. I want to congratulate you, Mr. Chairman, and your Budget Committee on the fine job you all do. Keep up the fight.

The CHAIRMAN. Thank you very much, Mr. Chairman. Thank you very much.

At this time we call Congressman Moody to the witness table. Congressman Moody, we want to welcome you as a Member who entered the House of Representatives displaying a long-term interest in deficit reduction, dealing with economic policy, and making sure that we have the right priorities, while at the same time reducing the deficit.

You have been involved in the budget process. Although you have not been a member of this committee, you have demonstrated outstanding leadership. We want to gain your views as a Member who is deeply concerned about the growing deficits and the methods that we use to resolve the deficit issue.

Congressman Moody, we invite you to submit your written testimony for the record and to summarize the major points of concern and recommendation that you have for us. Would you proceed.

STATEMENT OF HON. JIM MOODY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. MOODY. Thank you, Mr. Chairman. I will be brief. And thank you for including me in the hearing in Chicago. I think the field hearings are excellent. Certainly that one was.

I have three points to make.

First, I believe that taxes should be part of the solution, part of the mix.

Second, I think Social Security should also be very much part of the mix, and the solution.

Third, I think selling assets off, as the administration has proposed, is illusory as a way of reducing the deficit.

On my first point about taxes, I would like to call them tax restorations, because, in fact, we unintentionally overcut taxes in 1981. You will recall that in 1981 we were in a period of very rapid inflation. We consciously did not index the tax system until 1984, and we expected a great deal of revenues to be coming in purely as a result of inflation. As you know, the elasticity of revenues with respect to inflation is very high, however, inflation dropped. In 1982 and 1983, inflation was much lower, and consequently the tax revenues received by the Federal Government were much lower than most economists and budget analysts predicted at that time. The revenues, in fact, dropped to a historically low level of about 18 percent of GNP. They dropped a whole point in one single year; 1982.

My point, Mr. Chairman, is that tax revenues that we are now living on are much lower than were anticipated when we cut taxes in 1981 because of the inflationary effects.

Second, we must go after tax expenditures. Dollars lost through the back door of tax expenditures does the same thing to the budget deficit as a dollar spent through the front door of the appropriations process. We now have tax expenditures that total approximately $400 billion per year in this Nation, almost double the size of the budget deficit. Failure to recapture some of those tax expenditures gives preference to one form of budgetary outflow, tax breaks, over another form of budgetary outflow, spending.

Let me give you an example. General Electric earned almost $10 billion over the recent 4-year period and paid no taxes. If they had

paid the normal statutory rate of 46 percent, they would have paid about $4.6 billion in taxes.

Mr. Chairman, that is a tax expenditure of $4.6 billion to one company over a 4-year period. Is an extra dollar of tax break to General Electric really more important to the Nation than saving the lives of children?

In Chicago, we heard moving testimony, from Marian Edelman about how we are reducing immunizations; one of the most cost-effective ways of saving children's lives. We are cutting Medicaid, the most important program for prenatal care for children in their early lives. We now know that a black child born in Chicago has a higher chance of dying in the first year after birth than a child born in Cuba or Costa Rica. Child mortality has been increasing dramatically in this country.

Is it really more important to spend more money on tax expenditures than it is to spend it through the appropriations process? I think it is the time to look at that side of the ledger.

Third, it is now a very favorable time to look at taxes. We are not in a fragile economic condition. We have a number of favorable things going for us. A drop in oil prices is one of the most obvious and most recent and the OMB is suggesting a 4-percent growth rate over the upcoming period. CBO has more cautiously predicted 3.1 percent growth. Those are very favorable numbers. It's now a perfect period to have a tax increase without endangering the recovery.

In fact, the President's budget has already lost its virginity on taxes. It puts in $6.3 billion in taxes, while saying it is a no-tax-increase budget.

The only real question is, what is the right level of taxes and what is the right mix of taxes, not are there going to be any taxes. There are taxes in this budget.

My recommendation, Mr. Chairman, is that we tax Social Security benefits far more than we are now doing. I would also suggest that we tax energy, and I have personally sponsored a bill to do that. Each penny of tax increase at the pump yields $1 billion, and it would aid fuel conservation as well.

Let me briefly turn to Social Security. I respectfully disagree with our honored senior citizen of this body. I think wealthy Social Security recipients should pay taxes, and Social Security should be a part of the mix of the solution to the crisis that we are facing with respect to the budget deficit.

Social Security is the most rapidly increasing part of the budget, other than interest charges themselves. Social Security was $80 billion in 1977; it will be $212 billion in 1987, a 300-percent increase in a short 10 years and a 7-percent growth rate just in 1987 alone. It is now 20 percent of all Government expenditures.

We must acknowledge that Social Security, whether in surplus or in deficit, directly affects the key aspect of the deficit—that is, the drainoff of national savings from productive private investment into less productive Government spending. Every single dollar of Social Security in surplus is exactly $1 less that the Government must borrow from the public at large and therefore the private sector since surpluses are lent directly to the Government by statute.

Therefore, it is important that we keep Social Security in a consolidated budget, and I hope that all members of this budget panel will resist efforts to pull the Social Security numbers out of the budget, because the key economic question is, what is the drainoff from the private sector.

Mr. Chairman, my next point is that senior citizens are no longer the poorest people in our society. The incidence of poverty among young people is now 20 percent. If you are under 16, you have a 20 percent chance of living in poverty in America, far higher than those who are over 65. There are four times more children under 16 in poverty, Mr. Chairman, than there are citizens over 65 living in poverty.

Senior citizens receive far more from Social Security than they contribute. But it is not purely a social insurance program. It is a transfer program of massive proportions. When people who are now receiving Social Security began working, they were withheld at 1 percent; that existed until 1954. People are now being withheld at 7 percent, and it's going up in 1987 to 7.15 percent.

So, today's recipients receive an average of four times more than what they put in. It is a transfer program; it is not purely an insurance program.

My recommendation would be that we tax a portion of that Social Security benefit.

If we taxed everything that people received over and above what they actually put in, we would receive in 1987 dollars, $13.5 billion; $13.5 billion would significantly reduce our budget deficit. By 1991, that number would rise to $22.8 billion per year of tax receipts based on just taxing people above and beyond what they put in.

If that would be too difficult administratively and you simply went to something analogous to the private insurance tax rules where you taxed 85 percent of their benefits, we would receive $13 billion in 1987 and $20.9 billion in 1991.

That's a lot of money, and it would make a big dent in the budget deficit.

My final point is that selling assets, as the administration has proposed, is a totally illusory idea. First of all, if we take Federal assets and sell them to the public, you do exactly to the economy what you do when you sell them paper assets—you soak up private savings. What we're trying to do is reduce the drain on private savings by not forcing them to buy more bonds by raising up the interest rate. If you sell them physical assets, you are doing the exact same thing as if you sell them paper assets. You are soaking up private savings.

Now while this looks good in terms of the bookkeeping, it is illusory. It does nothing in the long run or even in the short. In fact, Mr. Chairman, in the long run, it would probably have an adverse impact on the deficit, because the revenues the Government receives from these assets in the form of student loans, small business loans, farm loans, and the rest of the revenues from this portfolio of assets that the Government wants to sell, would stop coming in to the Government. So, we'd get a quick hit on our short-term budget problem, and we'd pay for it in the long term through lower revenues in the outyears.

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Mr. Chairman, this would have a negative impact on outyear budget deficits.

So, those are the three main points. I appreciate the chance to make them.

The CHAIRMAN. Thank you, Congressman Moody. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. I have no questions, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Thank you, Mr. Chairman.

Let me just say to my dear friend, who is one of 56 great statesmen in this body last year, that I couldn't agree with you more. I appreciate very much the dedication that you've had to this problem, the political courage that I think you've exhibited, and I think you've found pretty much the same thing back home that I've found through the last several years. When you go back home and you really talk about these things openly and honestly with people, and they perceive that you're absolutely trying to do something that's fair and solve the problem, that they support what you're doing.

So, I just appreciate the gentleman very much and hope that he'll continue, which I know he will, that leadership during this session, because I think your leadership is important.

Mr. MOODY. Thank you.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. It's especially good to see one of my classmates up here before this panel and to give such thoughtful and sensible testimony. So, I would add my voice to those that have preceded me in commending you for your testimony, and I also would like to express my appreciation to you for a courageous vote on the Leath-Slattery-MacKay budget plan last year. Good to see you.

Mr. MOODY. Thank you.

The CHAIRMAN. The gentleman from Texas, Mr. Frost.

Mr. FROST. I would just add that the testimony was excellent, and we appreciate your appearing.

Mr. MOODY. Thank you.

The CHAIRMAN. Thank you, Congressman Moody. And now we would like to call to the witness table Congressman Norman Mineta.

We welcome Congressman Mineta to the Budget Committee as the senior member of the Public Works and Transportation Committee, but more importantly as one who served as a member of the Budget Committee for 6 years with distinction. He is someone who knows the budget process, knows all the difficulties and the tough choices that we face.

Congressman Mineta, we invite you to summarize your testimony. Your full testimony will be submitted for the record.

STATEMENT OF HON. NORMAN Y. MINETA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. MINETA. Thank you very much, Mr. Chairman. I will submit this copy for the record.

Mr. Chairman, I really appreciate this opportunity to appear before this distinguished panel, and I would also like to express my

appreciation to you for the privilege of participating in your field hearing of February 14 in San Francisco. It really reminded me of how much I enjoyed serving on the Budget Committee.

In my testimony today, I would like to first highlight the major impacts of the President's fiscal year 1987 budget proposals on civil aviation and then address what the Gramm-Rudman-Hollings cuts will mean for aviation safety during the current year and next year, as well as for reauthorization of aviation user taxes and the airport and airway improvement programs.

To conclude, I would like to then step back from my role as Chair of the Aviation Subcommittee and offer some broader commentary on the overall budget process.

With respect to aviation, I am pleased that the President's fiscal year 1987 budget has placed the administration on the record in support of adding 500 air traffic controllers and 138 air carrier and aircraft safety inspectors. However, the budget plays somewhat of a bait-and-switch game on the users of the aviation system.

Abrogating the 1970 trust with aviation taxpayers, the administration now offers the following deal: We will meet unquestionable safety needs by hiring controllers and inspectors, if the Congress, airline passengers, general aviation pilots and shippers are willing to forget why they have been paying their ticket and gas taxes. In other words, forget the capital improvements that are needed. We are planning to use your taxes for subsidizing 75 percent of the FAA's operating budget.

Not satisfied with starting in 1987, the President's budget suggests that interest not be paid on the trust fund. The reason for this $790 million grab is to pay back past FAA operating costs from the trust fund, costs that go back to October 1981. To add insult to injury, the President's budget would then cut the three programs that are supposed to be supported by the trust fund by some 30 percent from their authorized levels.

In the facilities and equipment account alone, the fiscal year 1987 cut will bring the shortfall between appropriations and authorizations since 1982 to $1.2 billion. For the Airport Improvement Program, the 5-year shortfall will equal $665 million against an unfunded backlog of more than $3 billion in airport construction funds. In research, engineering and development, $300 million that could have been funding terminal Doppler radar or explosives detection equipment has not been provided over the same time period.

Now I would like to shift to how the so-called Budget Deficit Reduction Act will affect the future of the aviation trust fund and the programs that it supports.

The 1982 Airway and Airport Improvement Act was a mutual commitment between the Federal Government and the aviation industry to look to the long-term needs of the airport and airway system, to provide funding for needed growth and improved efficiency through the introduction of new technology, and to build in a financial mechanism equal to doing the job.

Unfortunately, the Federal Government has repeatedly reneged on its commitment, while the users have continued to make good-faith payments into the trust fund. As a result, the trust fund at the beginning of fiscal year 1987 will have approximately a $4.3 bil-

lion uncommitted surplus or balance. This represents $4.3 billion that aviation users have paid in taxes that has not been spent on needed aviation safety and capacity improvements. The President's budget would leave us at the end of fiscal year 1987 with a surplus of $5.5 billion.

Despite the Airport and Airway Trust Fund's ever increasing surplus and the continuing payment of taxes in good faith, aviation's dedicated revenues continue to be surreptitiously used to avoid having to cut general fund programs.

Now to prevent this from continuing to happen, I have tried various remedies. Just last October, the House came within nine votes of removing the aviation trust fund from the unified budget and the congressional budget. But that was before enactment of Gramm-Rudman-Hollings, which brings me to my next topic.

In just 3 days, the Federal Aviation Administration will have to cut about $125 million from its operating budget and another $88 million from the Airport Improvement Program and air traffic control facilities and equipment. This is likely to produce increased flight delays, because the capacity of the air traffic control system is going to be whittled back. Much of the equipment needed to modernize air traffic control, communications, and weather detection systems will have to be either deferred or even canceled.

On the ground, the drying up of Federal assistance for needed airport improvements will also begin this year. While for this year, FAA has indicated that it intends to proceed with the hiring of needed safety inspectors, air traffic controllers, and security personnel, a supplemental appropriation will be needed if 8- to 10-week furloughs of nonsafety personnel are to be avoided over the next 30 weeks.

The Secretary of Transportation announced her intent to ask OMB for a so-called nonmonetary or zero dollar supplemental in testimony last Thursday before the House Transportation Appropriations Subcommittee.

Obviously, I must support funding for the personnel essential to aviation safety and security, but I must also alert you to the fact that even a zero-dollar supplemental has to get its funds from somewhere. For the current year, I must also point out an apparent discrepancy in the base that the Department of Transportation and the FAA are using as far as how many air traffic controllers are to be on board at the end of fiscal year 1986. Just last week, I heard an FAA official and Secretary Dole either mis-add or ignore the numbers so clearly written on page 318 of the conference report on the fiscal year 1986 continuing resolution, and that is that 500 controllers are to be added this year to the 14,306 controller positions that existed in fiscal year 1985.

Thus by focusing on the short term, as Gramm-Rudman-Hollings forces us to do, the safety of aviation should not be compromised by the March 1 sequestration cuts. The inherent safety of the system will be assured by passage of the supplemental. This luxury unfortunately will not be possible in fiscal year 1987, which will start in just 8 months, for under the most optimistic of circumstances, cuts of 15 percent, three times higher than this year's, will be needed to meet the prescribed deficit limit. The more likely cuts will take

away at least one-fourth of FAA's budget, leaving no room for even safety considerations.

So in only 8 months, Gramm-Rudman-Hollings, meat-ax will slice away controllers, inspectors, and airport security officials. Through its indiscriminate sequestration orders, Gramm-Rudman-Hollings will in less than a year irreparably tear apart the aviation system that it has taken us 50 years to build. It will do so with no regard for the self-supporting, user-financed aviation trust fund, which pays for all of these airport and air traffic control improvements and a portion of air traffic control operations. It will do so, ignoring the ever-increasing surplus in the aviation trust fund, not allowing its use for the intended purposes, but using its dollars to offset the overall general deficit in a great bookkeeping sham.

As was noted by President Reagan in his January 7 press conference, these very circumstances led to the exemption of Social Security from Gramm-Rudman-Hollings' provisions. And not to do so, in the President's words, would have been, as he said, "not playing fair with the people."

And so taking the President's words to heart, I will be working to do the same for the aviation trust fund.

Now to conclude, I ask the committee's patience, Mr. Chairman, as I change hats and take off that of being Chair of the Aviation Subcommittee and don the broader one, worn best pernaps by members of the Budget Committee, and I would like to start with the following quotation:

> A crisis is a time when leadership and ideologies begin to falter. It is a time when established standards fall, and customary procedures yield unexpected results. It is a time when all alternatives, including no choice at all, become calculated risks.

Now when Theodore Lowi wrote this to begin the prologue of the book, "The End of Liberalism," the year was 1969, and he was describing the 1960's as a decade of crisis that called into question public authority and the very ability of our governmental institutions to function. Having weathered the turmoil and upheaval of the civil rights and antiwar movements, as well as the direct challenge of Watergate, we have assumed the system to be righted.

I would suggest, however, that the enactment of Gramm-Rudman-Hollings is no aberration. Rather it is a logical conclusion of Government by single interest that Lowi described in his book. Gramm-Rudman-Hollings is a testimony to the effectiveness of all of our well-orchestrated individual issue-oriented initiatives. In a shortsighted and overzealous way, the so-called Balanced Budget and Emergency Deficit Control Act was clearly an act of desperation. Perhaps it was an inadvertent attempt by Congress to force itself out of the system of interest groups, political action committees, congressional subcommittees, caucuses and task forces that has us stymied.

The last time such an initiative was tried was in 1974 with the statute that set up this committee and the congressional budget process. The legislative intent then, as now, had to do with controlling spending. It also had to do with having the legislative branch set overall priorities, cutting across functional areas and single interests.

Unfortunately, our need to have a Gramm-Rudman-Hollings Act can only be read as some kind of an acknowledgement that the congressional budget process has failed. For a complex set of reasons, it has not been able to overcome the institutional pressures pressing us or pushing us into our more narrow interests. This set of pressures has me here today as Chair of the Aviation Subcommittee.

Now while I obviously have chosen to serve as an advocate for aviation safety, I must also raise these broader questions. For unless we have the courage to exercise our political will and to step beyond our individual interests, the crisis will only deepen our inability to act. We must make the necessary but difficult choices. To do otherwise, will prevent us from controlling ourselves. If we do not act, our desire to avoid conflict will preclude our very ability to govern.

Thank you very, very much, Mr. Chairman, for your patience.

[Testimony resumes on p. 651.]

[The prepared statement of Mr. Mineta follows:]

PREPARED STATEMENT OF HON. NORMAN Y. MINETA

THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE BUDGET COMMITTEE, FOR THE OPPORTUNITY TO APPEAR BEFORE THIS DISTINGUISHED PANEL. I WOULD ALSO LIKE TO EXPRESS MY APPRECIATION TO CHAIRMAN GRAY FOR THE PRIVILEGE OF PARTICIPATING IN YOUR FEBRUARY 14TH FIELD HEARING IN SAN FRANCISCO. IT REMINDED ME OF HOW MUCH I ENJOYED SERVING ON THE BUDGET COMMITTEE.

IN MY TESTIMONY TODAY, I WOULD LIKE TO FIRST HIGHLIGHT THE MAJOR IMPACTS OF THE PRESIDENT'S FISCAL YEAR 1987 BUDGET PROPOSALS ON CIVIL AVIATION AND THEN ADDRESS WHAT THE GRAMM-RUDMAN-HOLLINGS ACT'S CUTS WILL MEAN FOR AVIATION SAFETY DURING THE CURRENT YEAR AND NEXT YEAR AS WELL AS FOR REAUTHORIZATION OF AVIATION USER TAXES AND THE AIRPORT AND AIRWAY IMPROVEMENT PROGRAMS. TO CONCLUDE, I WOULD LIKE TO STEP BACK FROM ROLE AS CHAIRMAN OF THE AVIATION SUBCOMMITTEE AND OFFER SOME BROADER COMMENTARY ON THE OVERALL BUDGET PROCESS.

WITH RESPECT TO AVIATION, I AM PLEASED THAT THE PRESIDENT'S FY 87 BUDGET HAS PLACED THE ADMINISTRATION ON THE RECORD IN SUPPORT OF ADDING 500 AIR TRAFFIC CONTROLLERS AND 138 AIR CARRIER AND AIRCRAFT SAFETY INSPECTORS. HOWEVER, THE BUDGET PLAYS SOMEWHAT OF A "BAIT AND SWITCH" GAME ON THE USERS OF THE AVIATION SYSTEM. THE USERS HAVE BEEN PAYING TAXES SINCE 1970 ASSUMING THEIR USER FEES WOULD BE FUNDING MODERNIZATION OF THE AIR TRAFFIC CONTROL FACILITIES AND EQUIPMENT AS WELL AS SAFETY AND CAPACITY IMPROVEMENTS TO LOCAL AIRPORTS.

ABROGATING THE 1970 TRUST WITH THE AVIATION TAXPAYERS, THE ADMINISTRATION NOW OFFERS THE FOLLOWING DEAL: WE'LL MEET UNQUESTIONABLE SAFETY NEEDS BY HIRING CONTROLLERS AND INSPECTORS IF THE CONGRESS, AIRLINE PASSENGERS, GENERAL AVIATION PILOTS AND SHIPPERS ARE WILLING TO FORGET WHY THEY HAVE BEEN PAYING THEIR TICKET AND GAS TAXES.

IN OTHER WORDS, FORGET THE NEEDED CAPITAL IMPROVEMENTS, WE ARE PLANNING TO USE YOUR TAXES FOR SUBSIDIZING 75% OF FAA'S OPERATING BUDGET. NOT SATISFIED WITH STARTING IN 1987, THE PRESIDENT'S BUDGET SUGGESTS THAT INTEREST NOT BE PAID ON THE TRUST FUND. THE REASON FOR THIS $790 MILLION GRAB IS TO PAY BACK PAST FAA OPERATING COSTS FROM THE TRUST FUND, COSTS THAT GO BACK TO OCTOBER 1, 1981.

TO ADD INSULT TO INJURY, THE PRESIDENT'S BUDGET WOULD CUT THE THREE PROGRAMS THAT ARE SUPPOSED TO BE SUPPORTED BY THE TRUST FUND BY 30% FROM THEIR AUTHORIZED LEVELS. OBVIOUSLY, THESE CUTS WILL SLOW UP AND PERHAPS ELIMINATE VITAL SAFETY AND CAPACITY IMPROVEMENTS AT LOCAL AIRPORTS AND WILL FURTHER DELAY AND CURTAIL MODERNIZATION OF THE AIR TRAFFIC CONTROL SYSTEM. AT THE SAME TIME, FUTURE SAFETY IMPROVEMENTS WILL NOT BE DISCOVERED OR DEVELOPED WITH CUTBACKS IN RESEARCH EFFORTS.

In the Facilities and Equipment account alone, the FY 87 cuts will bring the shortfall between appropriations and authorizations since 1982 to $1.2 billion. For the Airport Improvement Program, the five year shortfall will equal $665 million against an unfunded backlog of more than $3 billion in airport construction grants. In research, engineering and development, $300 million that could have been funding terminal doppler radar or explosives detection equipment has not been provided over the same time period.

More detailed information on the impacts of the budget proposal on aviation programs is contained in the Views and Estimates Report that will be submitted to your Committee by the House Public Works and Transportation Committee today.

I would like to now shift to how the so-called budget deficit reduction act will affect the future of the aviation trust fund and the programs it supports.

The 1982 Airport and Airway Improvement Act was a mutual commitment between the Federal government and the aviation industry to look to the long-term needs of the airport and airway system, to provide funding for needed growth and improved efficiency through the introduction of new technology, and to build in a financial mechanism equal to doing the job. Unfortunately, the Federal government has repeated reneged on its commitment, while the users have continued to make good faith payments into the Trust Fund.

NOT ONLY THE EXECUTIVE BRANCH, BUT MY COLLEAGUES IN THE CONGRESS AS WELL, CONTINUE TO TAKE LESS THAN SERIOUSLY THE AGREEMENT MADE IN OUR 1982 LEGISLATION. AS A RESULT THE TRUST FUND AT THE BEGINNING OF FY 87 WILL HAVE APPROXIMATELY A $4.3 BILLION UNCOMMITTED SURPLUS OR BALANCE. THIS REPRESENTS $4.3 BILLION THAT AVIATION USERS HAVE PAID IN TAXES THAT HAS NOT BEEN SPENT ON NEEDED AVIATION SAFETY AND CAPACITY IMPROVEMENTS.

THE PRESIDENT'S BUDGET WOULD LEAVE US AT THE END OF FISCAL YEAR 1987 WITH A SURPLUS OF $5.5 BILLION.

DESPITE THE AIRPORT AND AIRWAY TRUST FUND'S EVER-INCREASING SURPLUS AND THE CONTINUING PAYMENT OF TAXES IN GOOD FAITH, AVIATION'S DEDICATED REVENUES CONTINUE TO BE SURREPTITIOUSLY USED TO AVOID HAVING TO CUT GENERAL FUND PROGRAMS.

TO PREVENT THIS FROM CONTINUING TO HAPPEN, I HAVE TRIED VARIOUS REMEDIES. I HAVE SUPPORTED LEGISLATION TO PROVIDE A SEPARATE PROCESS FOR CAPITAL BUDGETING AT THE FEDERAL LEVEL, INSERTED A "PAY-AS-YOU-GO" AMENDMENT FOR TRUST FUNDS IN THE FY 1985 BUDGET RESOLUTION, TESTIFIED REPEATEDLY BEFORE THE WAYS AND MEANS AND APPROPRIATIONS COMMITTEES, AND AUTHORED LEGISLATION TO AMEND THE BUDGET ACT TO ALLOW TRUST FUND PROGRAMS TO EXPEND WHAT THEY COLLECT IN REVENUES.

JUST LAST OCTOBER, THE HOUSE CAME WITHIN NINE VOTES OF REMOVING THE AVIATION TRUST FUND FROM THE UNIFIED BUDGET AND THE CONGRESSIONAL BUDGET. BUT THAT WAS BEFORE ENACTMENT OF GRAMM-RUDMAN-HOLLINGS, WHICH BRINGS ME TO MY NEXT TOPIC.

IN JUST THREE DAYS, THE FEDERAL AVIATION ADMINISTRATION WILL HAVE TO CUT ABOUT $125 MILLION FROM ITS OPERATING BUDGET AND ANOTHER $88 MILLION FROM THE AIRPORT IMPROVEMENT PROGRAM AND AIR TRAFFIC CONTROL FACILITIES AND EQUIPMENT. WHILE A 4.3 PERCENT CUT DOES NOT SOUND LIKE MUCH FROM AN OVERALL BUDGET THAT COMES CLOSE TO $5 BILLION, IT IS LIKELY TO CAUSE THE CLOSING OF SOME OF OUR SMALLER AIR TRAFFIC CONTROL TOWERS.

IT IS ALSO LIKELY TO PRODUCE INCREASED FLIGHT DELAYS BECAUSE THE CAPACITY OF THE AIR TRAFFIC CONTROL SYSTEM IS GOING TO BE WHITTLED BACK. MUCH OF THE EQUIPMENT NEEDED TO MODERNIZE AIR TRAFFIC CONTROL, COMMUNICATIONS AND WEATHER SYSTEMS WILL HAVE TO BE DEFERRED OR EVEN CANCELLED.

ON THE GROUND, THE DRYING UP OF FEDERAL ASSISTANCE FOR NEEDED AIRPORT IMPROVEMENTS WILL BEGIN THIS YEAR. IF AIRPORT DEVELOPMENT AND EXPANSION CANNOT BE FUNDED LOCALLY, IT IS LIKELY NOT TO HAPPEN AT ALL WITH GRAMM-RUDMAN'S ACROSS-THE-BOARD CUTS.

WHILE, FOR THIS YEAR, FAA HAS INDICATED THAT IT INTENDS TO PROCEED WITH THE HIRING OF NEEDED SAFETY INSPECTORS, AIR TRAFFIC CONTROLLERS AND SECURITY PERSONNEL, A SUPPLEMENTAL APPROPRIATION WILL BE NEEDED IF 8 TO 10 WEEK FURLOUGHS OF NON-SAFETY PERSONNEL ARE TO BE AVOIDED OVER THE NEXT 30 WEEKS. THE SECRETARY OF TRANSPORTATION ANNOUNCED HER INTENT TO ASK OMB FOR A SO-CALLED NON-MONETARY OR, $-0-, SUPPLEMENTAL IN TESTIMONY LAST THURSDAY BEFORE THE HOUSE APPROPRIATIONS COMMITTEE. OBVIOUSLY, I MUST SUPPORT FUNDING FOR THE PERSONNEL ESSENTIAL TO AVIATION SAFETY AND SECURITY. I MUST ALSO ALERT YOU TO THE FACT THAT EVEN $-0- SUPPLEMENTALS HAVE TO GET THEIR FUNDS SOMEWHERE.

FOR THE CURRENT YEAR, I MUST ALSO POINT OUT TO AN APPARENT DISCREPANCY IN THE BASE THAT DOT AND FAA ARE USING AS FAR AS HOW MANY AIR TRAFFIC CONTROLLERS ARE TO BE ON BOARD AT THE END OF FY 86. JUST LAST WEEK I HEARD AN FAA OFFICIAL AND SECRETARY DOLE EITHER MIS-ADD OR IGNORE THE NUMBERS SO CLEARLY WRITTEN ON PAGE 318 OF THE CONFERENCE REPORT ON THE FY 86 CONTINUING RESOLUTION -- THAT IS, THAT 500 CONTROLLERS ARE TO BE ADDED THIS YEAR TO THE 14,300 CONTROLLER POSITIONS THAT EXISTED IN FY 85.

THUS, BY FOCUSING ON THE SHORT-TERM, AS GRAMM-RUDMAN-HOLLINGS FORCES US TO DO, THE SAFETY OF AVIATION SHOULD NOT BE COMPROMISED BY THE MARCH 1 SEQUESTRATION CUTS.

THE INHERENT SAFETY OF THE SYSTEM WILL BE ASSURED BY PASSAGE OF A SUPPLEMENTAL.

THIS LUXURY WILL NOT BE POSSIBLE IN FISCAL YEAR 1987, WHICH WILL START IN JUST EIGHT MONTHS. FOR UNDER THE MOST OPTIMISTIC OF CIRCUMSTANCES, CUTS OF 15% -- THREE TIMES HIGHER THAN THIS YEAR'S -- WILL BE NEEDED TO MEET THE PROSCRIBED DEFICIT LIMIT. THE MORE LIKELY CUTS WILL TAKE AWAY AT LEAST ONE-FOURTH OF FAA'S BUDGET, LEAVING NO ROOM FOR EVEN SAFETY CONSIDERATIONS.

SO, IN ONLY EIGHT MONTHS, GRAMM-RUDMAN'S MEAT AX WILL SLICE AWAY CONTROLLERS, INSPECTORS AND AIRPORT SECURITY OFFICIALS. IT WILL DESTROY THE AIRWAY SYSTEM AT THE SAME TIME IT DRIES UP FEDERAL CONTRIBUTIONS FOR IMPROVING OUR AIRPORTS.

THROUGH ITS INDISCRIMINATE SEQUESTRATION ORDERS, GRAMM-RUDMAN WILL, IN LESS THAN A YEAR, IRREPARABLY TEAR APART THE AVIATION SYSTEM IT HAS TAKEN US 50 YEARS TO BUILD.

IT WILL DO SO WITH NO REGARD FOR THE SELF-SUPPORTING, USER FINANCED AVIATION TRUST FUND WHICH PAYS FOR ALL OF THESE AIRPORT AND AIR TRAFFIC CONTROL IMPROVEMENTS AND A PORTION OF AIR TRAFFIC CONTROL OPERATIONS. IT WILL DO SO IGNORING THE EVER-INCREASING SURPLUS IN THE AVIATION TRUST FUND, NOT ALLOWING ITS USE FOR THE INTENDED PURPOSES, BUT USING ITS DOLLARS TO OFFSET THE OVERALL GENERAL DEFICIT IN A GREAT BOOKKEEPING SHAM.

AS WAS NOTED BY PRESIDENT REAGAN IN HIS JANUARY 7 PRESS CONFERENCE, THESE VERY CIRCUMSTANCES LED TO THE EXEMPTION OF SOCIAL SECURITY FROM GRAMM-RUDMAN'S PROVISIONS. NOT TO DO SO IN THE PRESIDENT'S WORDS, WOULD HAVE BEEN "NOT PLAYING FAIR WITH THE PEOPLE."

TAKING THE PRESIDENT'S WORDS TO HEART, I WILL BE WORKING TO DO THE SAME FOR THE AVIATION TRUST FUND.

TO CONCLUDE, I ASK THE COMMITTEE'S PATIENCE AS I CHANGE HATS AND TAKE OFF THAT OF THE AVIATION SUBCOMMITTEE CHAIRMAN AND DON THE BROADER ONE WORN BEST PERHAPS BY MEMBERS OF THE BUDGET COMMITTEE.

I WOULD LIKE TO START WITH THE FOLLOWING QUOTATION:

A CRISIS IS A TIME WHEN LEADERSHIP AND IDEOLOGIES BEGIN TO FALTER. IT IS A TIME WHEN ESTABLISHED STANDARDS FALL AND CUSTOMARY PROCEDURES YIELD UNEXPECTED RESULTS. IT IS A TIME WHEN ALL ALTERNATIVES, INCLUDING NO CHOICE AT ALL, BECOME CALCULATED RISKS. (END QUOTE)

WHEN THEODORE LOWI WROTE THIS TO BEGIN THE PROLOGUE OF THE END OF LIBERALISM, THE YEAR WAS 1969 AND HE WAS DESCRIBING THE SIXTIES AS A DECADE OF CRISIS THAT CALLED INTO QUESTION PUBLIC AUTHORITY -- AND THE VERY ABILITY OF OUR GOVERNMENTAL INSTITUTIONS TO FUNCTION.

HAVING WEATHERED THE TURMOIL AND UPHEAVAL OF THE CIVIL RIGHTS AND ANTIWAR MOVEMENTS, AS WELL AS THE DIRECT CHALLENGE OF WATERGATE, WE HAVE ASSUMED THE SYSTEM TO BE RIGHTED. I WOULD SUGGEST, HOWEVER, THAT ENACTMENT OF GRAMM-RUDMAN-HOLLINGS IS NO ABBERATION. RATHER, IT IS A LOGICAL CONCLUSION OF THE GOVERNMENT BY SINGLE INTEREST THAT LOWI DESCRIBED IN HIS BOOK.

GRAMM-RUDMAN-HOLLINGS IS A TESTIMONY TO THE EFFECTIVENESS OF ALL OUR WELL-ORCHESTRATED, INDIVIDUAL ISSUE-ORIENTED INITIATIVES. IN ITS SHORT-SIGHTED AND OVERZEALOUS WAY, THE SO-CALLED BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT WAS CLEARLY AN ACT OF DESPERATION.

PERHAPS IT WAS AN INADVERTENT ATTEMPT BY THE CONGRESS TO FORCE ITSELF OUT OF THE SYSTEM OF INTEREST GROUPS, POLITICAL ACTION COMMITTEES, CONGRESSIONAL SUBCOMMITTEES, CAUCUSES AND TASK FORCES THAT HAS US STYMIED.

THE LAST TIME SUCH AN INITIATIVE WAS TRIED WAS 1974, WITH THE STATUTE WHICH SET UP THIS COMMITTEE AND THE CONGRESSIONAL BUDGET PROCESS. THE LEGISLATIVE INTENT THEN, AS NOW, HAD TO DO WITH CONTROLLING SPENDING. IT ALSO HAD TO DO WITH HAVING THE LEGISLATIVE BRANCH SET <u>OVERALL</u> PRIORITIES, CUTTING ACROSS FUNCTIONAL AREAS AND SINGLE INTERESTS.

UNFORTUNATELY, OUR NEED TO HAVE A GRAMM-RUDMAN-HOLLINGS ACT CAN ONLY BE READ AS SOME KIND OF ACKNOWLEDGMENT THAT THE CONGRESSIONAL BUDGET PROCESS HAS FAILED. FOR A COMPLEX OF REASONS, IT HAS NOT BEEN ABLE TO OVERCOME THE INSTITUTIONAL PRESSURES PUSHING US INTO OUR MORE NARROW INTERESTS.

THIS SET OF PRESSURES HAS HAD ME HERE TODAY AS CHAIRMAN OF THE AVIATION SUBCOMMITTEE. WHILE I OBVIOUSLY HAVE CHOSEN TO SERVE AS AN ADVOCATE FOR AVIATION SAFETY, I MUST ALSO RAISE THESE BROADER QUESTIONS.

FOR UNLESS WE HAVE THE COURAGE TO EXERCISE OUR POLITICAL WILL AND TO STEP BEYOND OUR INDIVIDUAL INTERESTS, THE CRISIS WILL ONLY DEEPEN OUR INABILITY TO ACT.

WE MUST MAKE THE NECESSARY BUT DIFFICULT CHOICES. TO DO OTHERISE WILL PREVENT US FROM CONTROLLING OURSELVES. IF WE DO NOT ACT, OUR DESIRE TO AVOID CONFLICT WILL PRECLUDE OUR VERY ABILITY TO GOVERN.

THANK YOU.

The CHAIRMAN. Thank you very much, Congressman Mineta. Mr. Lowry.

Mr. LOWRY. No questions. Excellent statement.

The CHAIRMAN. The gentleman from Texas, Mr. Leath.

Mr. LEATH. Thank you, Mr. Mineta. That was an excellent statement, and I think it lends tremendous credibility to what many of us have been saying, that it's imperative that we write a budget, because there are things that don't need cutting. There are things that need increasing. And I think you've hit the nail right on target with airport safety. Thank you.

The CHAIRMAN. The gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Mineta, as you know, we devoted a substantial portion of our field hearings in Dallas on February 13 to aviation safety, and I have one or two questions, because your testimony today is an excellent addition to the testimony that we took in Dallas. My specific question is, short of taking the aviation trust fund off budget, how can we stop the administration from doing what you've outlined in your testimony, from dipping into that fund and using it for purposes other than safety?

Mr. MINETA. I do not think there really is much that we can do because the trust fund is subject to the appropriations process and subject to the Gramm-Rudman-Hollings Act. I suppose jawboning and pleading would be the only alternative.

But it is a subject that given what happened in 1985 in aviation, is a critical subject and that we ought not to let up. I am especially concered about the area of aviation inspectors because the FAA becomes the enforcer of the rules and regulations. They are the cops on the beat.

I have no quarrel with airlines management in a deregulated environment working to cut costs. That is their job. But whenever anybody is trying to cut corners that relate to safety and maintenance, as far as I am concerned the full force of the law and the FAA ought to come down on them.

We cannot afford not having inspectors there, as we experienced in 1983 with a 25 percent cutback in the inspector work force. That is when accidents start happening because someone is cutting corners.

Mr. FROST. Specifically, Mr. Mineta, if we did take the aviation trust fund off budget, would that single act in and of itself prevent

the administration from doing what they are trying to do in this budget, using those funds for purposes other than safety?

Mr. MINETA. Unfortunately, just taking the aviation trust fund off budget would not do it.

Mr. FROST. So what would we have to do?

Mr. MINETA. I think we have to have a specific exemption under the Gramm-Rudman-Hollings Act and treat the aviation trust fund in the same way that the Social Security trust fund is going to be treated.

Mr. FROST. But Norm, that goes just to the sequestration process. That does not go to the process at the front end of the budget. Even if we amended Gramm-Rudman-Hollings to say that sequestration did not apply to the aviation trust fund, what would we have to do to prevent the administration from dipping into that trust fund at the beginning of the budgetary process and recommending that we use it for other than safety?

Mr. MINETA. Well, we have a protection in the law right now. There has to be a two for one relationship between how much is spent for capital improvements and how much can be spent for operations.

I put that in the act in 1982 because I was afraid that the trust fund was going to be used for operating purposes. The purpose of the aviation trust fund is really for capital improvements to airports and the airspace system.

To the extent that they do not keep that ratio between capital and operating expenditures, then they in fact lose operating money. At least they have been kept to that 2 to 1 ratio and I think we have to keep that provision in law.

On the other hand, if sequestration hits us and we are faced with a 15 or 25 percent cut, then I guess I am going to have to eat my own words and take that two for one penalty out of the law. I would do so in order to make sure that we can take enough funds out of the trust fund to keep the necessary air traffic controllers on board.

In fiscal year 1984, all of you experienced delays. You got released from your gate and then you went out and taxied to what they would call the bullpen and you waited there. You waited there for 40 minutes, 1 hour, 1½ hours. I have heard of waits as long as 3 hours, all spent sitting in an airplane.

The summer of 1986 is not going to be any different. And now we have more planes. We also have more airlines. The airlines themselves are changing in the nature of their operation, going to hub and spoke operations. So there are more takeoffs and landings. And frankly, the load on the air traffic control system is great.

So when you are sitting there at the end of the runway, do not sit there and complain about the pilot or the airline or anybody else. It is simply that because of funding cuts the air traffic control system cannot handle the load. There is only so much concrete on the ground at the airport and there is only so much airspace in which you can put planes. If you do not have the air traffic controllers to be able to sequence the planes, to keep the separation both laterally and horizontally, there is just no other way to do it but hold planes on the ground.

Mr. FROST. Mr. Chairman, I know that we are pressed for time today, but this is an extraordinary matter, and I do not know—I am a little frustrated as to how we treat this. It seems to me that if we have time, sometime later, we really need to go into this in more detail because this is something that is going to have a direct impact on the public, an immediate impact on the public. It has some implications in terms of the structure of the budget process in addition to the dollars that are involved in this year.

I would hope that we would find some way to devote some more attention to this.

Mr. MINETA. Mr. Chairman, you will recall that I had meetings in Dallas as a result of the unfortunate and tragic accident involving Delta Flight 191, which occurred because of wind shear.

Now, we were talking originally in the National Air Space Plan installing of 174 next generation radars and 100 terminal Dopplers. In the President's budget they are now only talking about 15 terminal Dopplers to detect wind shear.

And yet, in the home area of Congressman Frost, a very tragic accident caused by wind shear made Delta Flight 191 go down.

That is the nature of what is happening here in this budget's and Gramm-Rudman-Hollings treatment of the aviation trust fund.

The CHAIRMAN. I certainly want to thank Congressman Mineta for his testimony and pointing out that the budget has major deficiencies with regard to air safety, as well as our investments. I know the interest that the gentleman from Texas and we all share in this subject. I think we are going to see a continuation of this issue. Also, as we look at alternatives in terms of priorities, the Budget Committee will be addressing this issue because of the leadership of people like Congressman Mineta who served on this committee, as well as Congressman Frost, who has articulated over and over again this same concern.

I want to thank Congressman Mineta for his testimony and for coming back to his old committee.

Mr. MINETA. Any time. Thank you very, very much.

The CHAIRMAN. At this time, the Chair calls to the witness table Congressman Stangeland.

Congressman Stangeland, we thank you for waiting. We are running about 30 minutes behind schedule and we hopefully will try to make up for some lost time. We would ask all of those who are waiting to testify to prepare to summarize your statements. They will be entered in their entirety into the record.

Congressman Stangeland, we welcome you to the Budget Committee and look forward to your testimony. Please proceed.

STATEMENT OF HON. ARLAN STANGELAND, REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. STANGELAND. Thank you, Mr. Chairman.

My statement is very brief and so I am going to read it and perhaps depart somewhat. But I should not take more than about 5 minutes.

I appreciate very much the opportunity to appear before the Budget Committee and afford me this opportunity to discuss what I

think is a very most important legislative proposal, which is my flat rate COLA benefit plan.

I am here before you with a plan which is a mechanism for saving billions of budget dollars. The Actuary of the Social Security Administration calculates savings of $2.4 billion in 1987; $5.5 billion in 1988; $8.3 billion in 1989; $11.1 billion in 1990; and $11.3 billion in 1991; and additional savings that will grow beyond that point.

The initiative changes the COLA formula of the Social Security system and sets the COLA as a flat rate dollar amount for all recipients of Social Security. Under the plan, the COLA for 1987 would be $11 per month per recipient with no stipulations. The figure is computed very simply by using the following formula: multiply the CPI for 1987, which is estimated at 3.7 percent, to the recipient at the 20th percentile income level now receiving $299 a month as an annuity from Social Security. The rate of increase per month is $11.

This proposal would give every Social Security recipient this COLA increase of $11, regardless of the amount of money each receives as his or her current monthly annuity.

This proposal is fair to all seniors and continues to help those at the lowest end of the system. Those recipients at the lower 20th percentile monthly allotment level will receive a larger COLA under this proposal than they do under the present system. The recipients at the highest 80 percent level will receive a lower monthly increase, however all beneficiaries will receive an additional monthly increase.

This proposal, I think, is the answer to producing an equitably balanced budget. The flat rate proposal allows Social Security to be trimmed without any injustice to any recipient. And I frankly believe that Social Security ought to be a contributor to our balanced budget process.

With the enactment of the flat rate COLA concept, several issues emerge. As we have computed the flat rate COLA, we found that nearly 10 million Social Security recipients would benefit with a higher COLA as a result of the flat rate COLA formula. These are the people in most need. In my estimation, this is one of the best ways to save the Social Security system by the flat rate COLA formula.

As we continue COLA's, we continue to enhance the high side and barely maintain the low side. As we continue the current system of COLA's we continue the disparity between the high and the low.

We ought, as well, to be applying this to civil service retirees, military retirees, and railroad retirees. The Social Security dollar flat rate amount is the same dollar amount that could be applied to those retiree accounts. After all, are not all senior citizens on a fixed income and if one deserves a cost-of-living increase, do not all deserve a cost-of-living increase?

The fairness of the proposal is the fact that the basic cost of living goes up the same whether you are earning $300 a month, $600 a month or $900 a month. There is not a cost-of-living differential of double between those at $300 a month and $600 a month.

The basic cost of living is the same for all retirees, just like the flat rate COLA. There is equity and fairness, but it grants COLA's to all.

Presently, this flat rate concept is encompassed in legislation H.R. 846. It was introduced in the 98th Congress and again in the 99th Congress. The bill has a few technical flaws that may be easily corrected, the "Prouty People" should be included to receive the flat rate COLA; a specific formula would have to be worked out so that those involved in the "family max" situation would not either greatly benefit or be adversely denied.

I will gladly furnish cost estimates from CBO should you desire those figures.

Let me say that everybody is deathly afraid to touch the Social Security question. I have discussed this proposal for 3 years. I have received editorials from major newspapers in my district favoring this proposal. I have discussed this with my senior citizens advisory committees. Members of that committee know full well that they will receive less under my formula because they are above that 20th percentile, but they say it is fair.

I, up to this date, have received one letter from my State in opposition to this proposal.

It is defensible. I think it is fair.

I would like to point out something else, and I am somewhat amazed, Mr. Chairman, that my colleagues to the right are in absentia here and I do not know if that is just by conflict scheduling or by design or what the reason is. I thought that I could give this once. Now I understand I am going to have to give it twice.

The CHAIRMAN. I would simply interrupt the distinguished gentleman from Minnesota just to say I cannot account for that. Earlier there were some Members from the Republican side here, but they have not been here for most of the witnesses since we returned from vacation.

Mr. STANGELAND. Let me say that some of my colleagues have said look, those who receive a higher annuity paid in at a higher rate. But I would like to remind the Budget Committee that nobody has a payroll deduction to accommodate a COLA. A COLA is not included in a payroll reduction. This is an overall, flat grant from the Federal Government to accommodate cost-of-living adjustments.

Frankly, Mr. Chairman, as well, I would like to say that I think Gramm-Rudman, if there is one good thing about it—there are a number of things and a number of bad things--but if there is one good thing, it may force us to reform our Federal retirement system, and the way we grant COLA's.

There are those who say that Social Security has an abundance of money now and there is no problem, we can grant COLA's because we got all kinds of dollars in the system. Yes, we have. But I think we ought to be looking, rather than 4, 5, 6, or 10 years down the road, we ought to be looking 20 and 30 years down the road. That system has excess dollars today because we now have all new Federal employees participating in the system.

But we are not thinking of what is going to happen to the civil service retirement system when those people are not paying in and the present civil service employees retire. That system is going to

be bankrupt. And we are going to have to make some adjustments 20 or 30 years down the road.

I think this gets us on the way of saving dollars, saving a system at least in part, and certainly contributes to the budget deficit problem that we have today.

And I would hope that this committee could be enlightened enough to finally accept what, in my estimation, is a responsible approach.

I would just like to talk about some of the other proposals to fix the COLA. There have been those who said let us just cut 2 points off the COLA we grant. That still maintains the disparity between the high and the low. It is punitive to the low, who need more. And it just is not the answer to the problem.

I think the answer is something along this flat rate COLA. And our indications show that the poverty level is about $300 per individual person. We are right close to that poverty level. If you want to be sure that you keep anyone from slipping into poverty, based on the COLA, grant the COLA at the poverty level. Use that figure, rather than the 20th percentile.

The 20th percentile was a figure that I just hatched out of the air. It turns out that it works real well, as far as the number of recipients in need.

With that, Mr. Chairman, I would be happy to respond to any questions.

[The prepared statement of Mr. Stangeland follows:]

PREPARED STATEMENT OF HON. ARLAN STANGELAND

Thank you, Mr. Chairman, and members of the House Budget Committee, for affording me this opportunity to discuss and explain this most important legislative proposal, the Stangeland Flat Rate COLA Benefit plan.

Mr. Chairman, I am here before you with a plan which is a mechanism for saving billions of budget dollars. The Actuary of the Social Security Administration calculates savings of $2.4 billion in 1987; $5.5 billion in 1988; $8.3 billion in 1989; $11.1 billion in 1990; and, $11.3 billion in 1991.

My initiative changes the COLA formula of the Social Security System and sets the COLA as a flat rate amount for all the recipients of Social Security. Under the plan, the COLA for 1987 is $11 per month per recipient with no stipulations. The figure is computed by using the following formula: multiplying the CPI for 1987, estimated at 4.3 percent—to the recipient at the 20th percentile income level, now receiving $294.80 a month as an annuity from Social Security—the rate of increase per month is $11. This proposal would give every Social Security recipient this COLA increase of $11 per month, regardless of the amount of money each receives as his/her current monthly annuity.

The proposal is fair to all our seniors and continues to help those at the lowest end of the system. Those recipients at the lower 20th percentile monthly allotment level will receive a larger COLA under this proposal than they do under the present system.

The recipients at the highest 80 percent level will receive a lower monthly increase; however, all the beneficiaries of Social Security will receive an additional monthly increase.

The proposal is the answer to producing an equitably balanced budget. This flat rate proposal allows Social Security to be trimmed without injustice to recipients.

With the enactment of the flat rate COLA concept, several issues emerge. As we have computed this flat rate COLA, we have found that there are nearly 10 million Social Security recipients who would benefit with a higher COLA as a result of the flat rate COLA formula. They are the people in the most need. In my estimation, this is one of the best ways to save the Social Security System by the installation of the flat rate COLA formula. As we continue COLA's, we continue to enhance the high side and barely maintain the low side.

We ought to be applying this to civil service retirees, military retirees and railroad retirees as well. The Social Security dollar flat rate amount is the same dollar amount that could be applied to those retiree accounts. After all, are not all senior citizens on a fixed income and deserve a cost-of-living increase. The fairness of the proposal is the fact that the basic cost of living goes up the same whether you are earning $300 a month, $600 a month or $900 a month. The basic cost of living is the same for all these retirees, just like the flat rate COLA. There is equity and fairness, but it grants COLA's to all.

Mr. Chairman, presently, my flat rate concept is encompassed in legislation H.R. 846. As introduced in the 98th Congress and again in the 99th Congress, the bill has a few technical flaws that may be easily corrected—the "Prouty People" should be included to receive the flat rate COLA; a specific formula would have to be worked out so that those involved in the "family max" situation would not either greatly benefit or be adversely denied.

I will gladly furnish you cost estimates from the Congressional Budget Office should you so desire those figures.

In addition, I have received strong support from Minnesota's Seventh Congressional constituents for the implementation of this Flat Rate COLA for Social Security.

This is a proposal that makes good sense, and, one, we, as a nation, cannot afford to abandon!

Thank you, Mr. Chairman, and members of the Budget Committee.

The CHAIRMAN. Thank you, Congressman Stangeland. I know of your interest in this area and certainly your proposal is a very intriguing one. The idea of a flat COLA which would, as I understand it, provide more money for those at the lower end of the spectrum. I do not have any questions, I am familiar with it. Certainly, it is going to be an idea that Members of Congress will be examining as they look at deficit reductions. Mr. Lowry.

Mr. LOWRY. Mr. Chairman, I just wanted to agree with you and I wanted to compliment our colleague for a good and courageous approach.

I am very interested in this as one avenue. Another one I am interested in is taxation of the Social Security benefits, which would get at the equity question also because of the progressive income tax. But we certainly have to get at this problem, and I congratulate you for your proposal.

Mr. STANGELAND. Well, thank you.

I happen to think that this proposal, when you think of the traditional perceptions of the two parties, this proposal is in the finest traditions of the Democrat party in that it takes care of those in the most need while not enhancing those who do not need.

So as a conservative Republican, I think I have got a great Democratic proposal here.

Mr. LOWRY. The gentleman certainly does because, as you pointed out, a COLA freeze—the problem with the COLA freeze is they hit that low income. A third of the people on Social Security's total incomes are under $10,000 a year, probably 15 percent's total is under $5,000.

So the gentleman really makes good points.

The CHAIRMAN. And the gentleman would also say—if I may add a point—you are also saying that even those who have paid into the system, they would all receive something under your proposal?

Mr. STANGELAND. That is right, yes. We do not means test the system by doing this, or anything, no.

The CHAIRMAN. So you avoid a freeze of a COLA, which drives people into poverty. However, at the same time you also avoid a means test, which therefore maintains what some people are con-

cerned about, the sacrosanct nature of the trust fund. I paid into it, I ought to get something out of it.

I want to thank the gentleman for his testimony, and certainly we will share it with the committee. I am sorry he will have to say it all over again for the members of his own party.

Mr. STANGELAND. I am going to be more than happy to say it all over again to them, Mr. Chairman. Thank you very much for the time.

The CHAIRMAN. Thank you.

At this time, the Chair is going to call to the witness table Congressman Weaver from Oregon; Congressman Udall from Arizona; and Congressman de Lugo who represents the Virgin Islands. We certainly want to welcome you.

I have asked you to sit together because I think each of you will be speaking from a different prospective about the same concern that you share mutually as you look at our responsibilities here.

With that in mind, we would ask you to submit your testimony for the record. It will be entered into the record in its entirety. Therefore, you should feel free to briefly summarize the major points you wish to share with the committee.

Let us begin with Congressman Weaver, then Congressman Udall, and Congressman de Lugo. We welcome all three of our distinguished colleagues to the Budget Committee.

STATEMENT OF HON. JIM WEAVER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON, AND CHAIRMAN, SUBCOMMITTEE ON GENERAL OVERSIGHT, NORTHWEST POWER AND FOREST MANAGEMENT OF THE COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

Mr. WEAVER. Thank you very much, Mr. Chairman. I am here to tantalize you with a $5 billion offer to help reduce the deficit. I am encouraging the Northwest States to purchase the Bonneville Power Administration from the Federal Government for $5 billion cash. That is dollars on the barrelhead, to reduce the deficit in any year you choose. If you want it this year, we can certainly see if we can go ahead and give you the $5 billion this year.

The CHAIRMAN. Can I interrupt the gentleman from Oregon? Are the States prepared to buy it tomorrow?

Mr. WEAVER. Excuse me?

The CHAIRMAN. Are the States prepared to buy it tomorrow? If so, we have a deal.

Mr. WEAVER. I have held two hearings on it, with administration technical witnesses such as the Corps of Engineers, the Bureau of Reclamation, the Bonneville Power Administration itself. They find no serious problems. The various problems such as dealing with the Canadian treaty on water storage on the Columbia system, the General of the corps said they could be the lead agency, could handle that nicely, that it would be an interstate compact of the four States that would do the buying and it would benefit the Northwest as well as the Federal Government.

I want to make this point, Mr. Chairman, and submit the rest of my testimony to you. The Bonneville Power Administration is self-financing. It is paid for by the ratepayers but also it makes the

Federal Government no money. You do not get a penny of profit from the Bonneville Power Administration other than the repayment of the Federal debt.

We will give it to you cash today, $5 billion, to reduce your deficit and I believe we can put together a consensus in the Northwest to do this particularly if the Budget Committee wants to take the lead.

[The prepared statement of Mr. Weaver follows:]

PREPARED STATEMENT OF HON. JIM WEAVER

Mr. Chairman and Committee Members:

I appreciate the opportunity to testify today on the $5 billion federal budget deficit reduction offered by H.R. 3215, the Pacific Northwest Power Authority Act, which Rep. Mike Lowry and I introduced last August.

This bill would transfer the existing federal transmission system and the output of federal power facilities in the Pacific Northwest to an interstate compact of Washington, Oregon, Idaho, and Montana for a price equal to the present value of BPA's existing repayment obligations to the U.S. Treasury: $5 billion. The new regional authority would obey existing federal laws governing the sale of power and protection of the environment, including fish and wildlife. Colloquially, this bill would enable the Pacific Northwest to "buy" the Bonneville Power Administration (BPA).

My Subcommittee has already conducted 2 hearings on this bill. On January 30, the Bonneville Power Administration (BPA), the Army Corps of Engineers, the Bureau of Reclamation, the Fish and Wildlife Service, and the National Marine Fisheries Service, all of it approved by OMB, was highly positive toward this proposal. None of the witnesses raised any insurmountable objections, and the Administration has concluded that sale of these federal power resources could be implemented by FY 1988. On February 10, the people of the Pacific Northwest expressed their views on this bill at a hearing in Portland, Oregon.

Chart 1 in my written testimony compares BPA's existing federal repayment obligation with the payments to retire the $5 billion of tax-exempt bonds necessary to finance the buyout. The existing obligation includes paying back, with interest, funds appropriated to the Corps and Bureau for dams, funds appropriated to BPA for transmission facilities, and funds borrowed by BPA from the U.S. Treasury for transmission and conservation.

The new repayment schedule would enable the regional authority to reduce wholesale power rates for the initial 6 years by about 7%. This would help keep our aluminum plants in business and help sell the region's massive surplus of federal firm power, which BPA now expects to persist for at least 10 years. After that, repayment requirements would remain level (at $410 million per year) until the year 2027.

Chart 2 shows the amounts BPA has borrowed from the U.S. Treasury for investment in transmission facilities and conservation since first authorized to do so in 1974, and the additional amounts BPA plans to borrow in the future. Under H.R. 3215, the Treasury would no longer be required to loan this money, thus further reducing federal budget obligations.

The Administration budget proposes to sell BPA for $8.85 billion, with payments spread over a 4-year period starting in FY 1988, which is equivalent to a present value of $7.4 billion. Thus, at this early stage, the competing offers are only $2.4 billion apart.

There have been suggestions that the sale price should be higher, but such plans fail to account for the fact that BPA is already the Pacific Northwest's high-cost wholesale power source. Chart 3 shows that, thanks primarily to the WPPSS fiasco foisted upon the region by the federal government, utilities with other power sources have lower rates than those which rely 100% on BPA. Setting a higher price would make the deal uneconomic; no one would buy it.

But for $5 billion, the Northwest could and should buy Bonneville and bring it home to the people who are already paying BPA's bills. The region should control its premier natural resource--running water. The federal government doesn't own the oil in Texas, the farmland of Iowa, the sunshine in Florida, or the ski slopes of Utah. If the Northwest must pay, the Northwest must have a say. The people of the region should decide whether to build new dams or irrigate new lands.

CHART 1

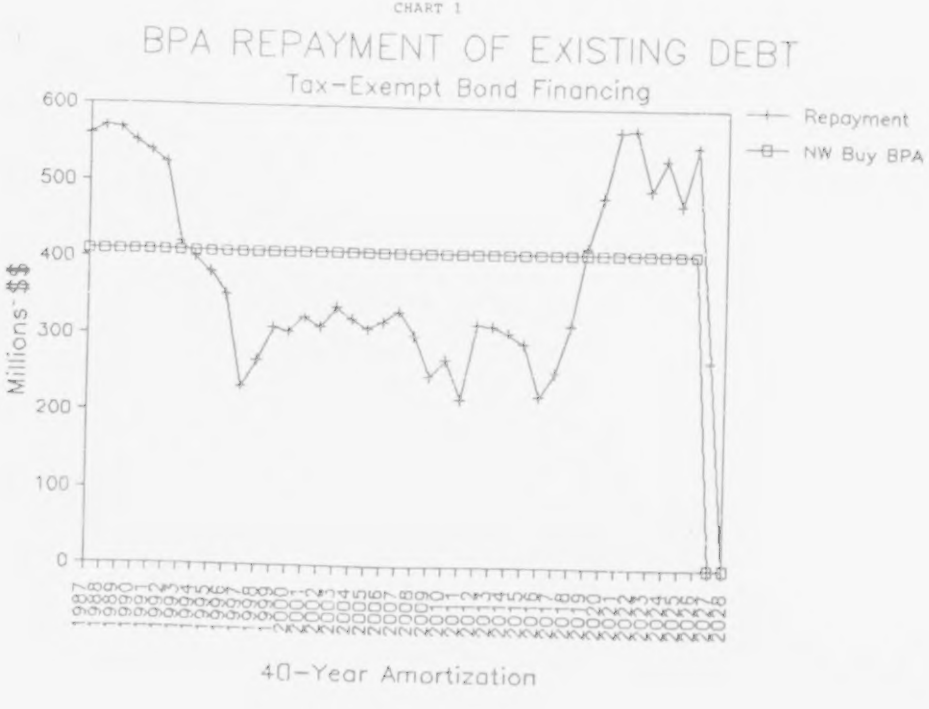


CHART 2

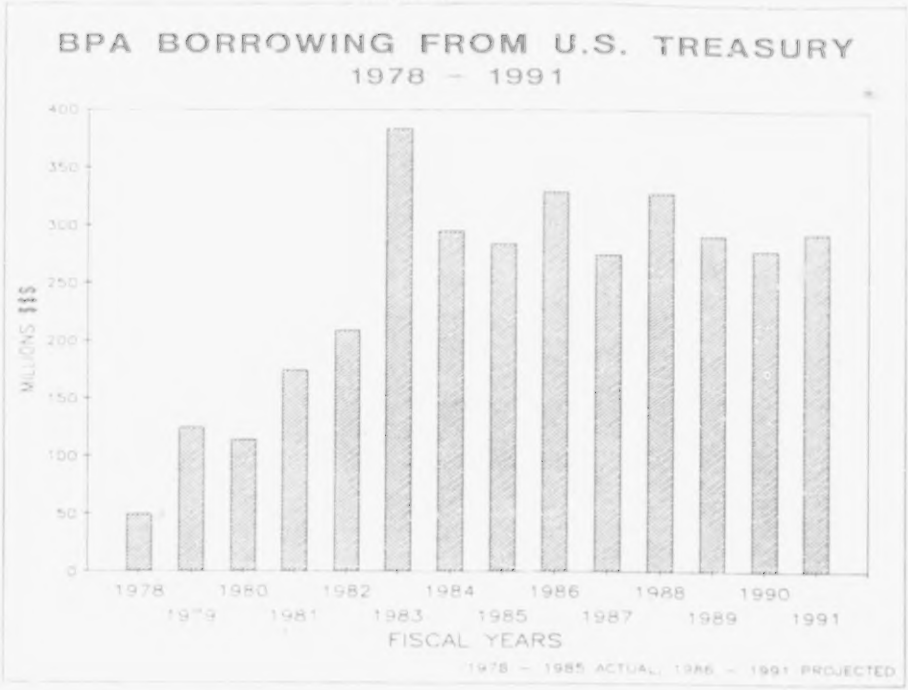
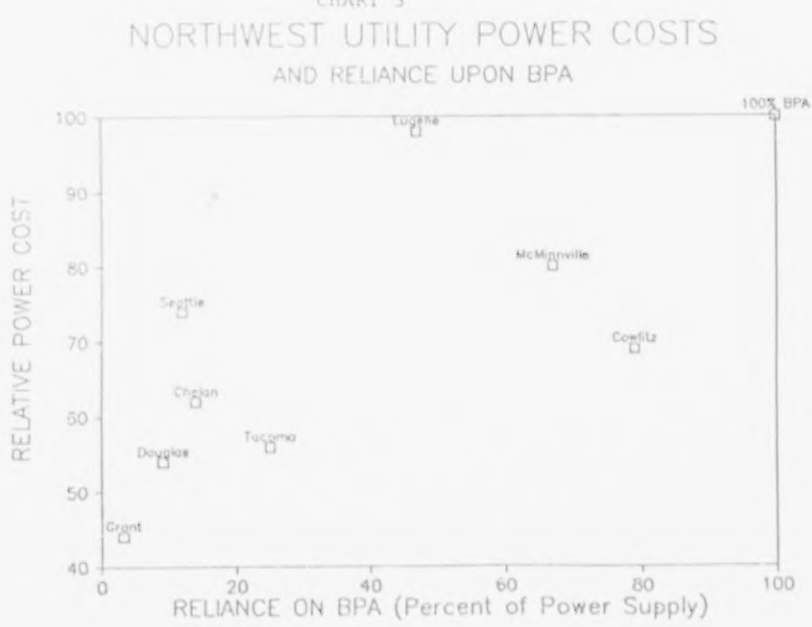


CHART 3



The CHAIRMAN. Thank you very much, Congressman Weaver. I would like to ask two brief questions. I know you have a heavy schedule and you may want to leave after that. Do you know of anyone in the private sector who seeks to purchase Bonneville as being proposed by the administration? What you are proposing is not a private sector sale.

Mr. WEAVER. Absolutely and categorically——

The CHAIRMAN. It is a regional government operation.

Mr. WEAVER. The people of the Northwest would buy it through an interstate compact. As far as I know, the regions' congressional delegations are absolutely and adamantly opposed to any sale to a private entity.

The CHAIRMAN. Bipartisanly, Republicans and Democrats?

Mr. WEAVER. Republicans and Democrats, as far as I know. For Governors of the Northwest States, one of them being a Republican, came out yesterday saying they were adamantly opposed to sale to private interests.

The CHAIRMAN. Is there any private sector group that you know that is interested?

Mr. WEAVER. I have only heard background gossip that several private utilities in the Northwest would take a look at it. I find from my hearings that it would be virtually impossible for a private interest to buy it because there is such an interinvolvement with various public matters and public policies. Fish policy, irrigation policy, and transportation policy, are so intimately wrapped up in the Columbia River system production of power, that to my mind it would be virtually impossible for a private entity to do this. It would have to be a governmental entity, if not the Federal Government, then an interstate compact.

The CHAIRMAN. Are you aware of the statement by the Republican Senator from Oregon, Senator Hatfield, who chairs the Appropriations Committee on the Senate side? He said "over my dead body."

Mr. WEAVER. You see, they confuse in the press constantly the sale to private interests and my regional compact.

The CHAIRMAN. He is talking about the private interests?

Mr. WEAVER. Senator Hatfield told me that personally, when I asked him this, he said, Jim, for heaven's sake, get the press to understand there is a difference between your proposal and the Reagan administration's proposal.

The CHAIRMAN. Is his comment in reference to the Reagan administration?

Mr. WEAVER. Absolutely. He did say that at this time he does not support the interstate compact. The Governors said the same thing. At the same time, they all say that Weaver's proposal warrants consideration, it may be something we want to move to, et cetera. The absolutely "over my dead body" language is all to the sale to private entities.

The CHAIRMAN. Thank you very much, Congressman Weaver.

Congressman Udall, one of the outstanding senior Members of the House of Representatives. We are delighted to welcome you, sir, to the Budget Committee. We are deeply honored by your presence and look forward with anticipation to your testimony.

STATEMENT OF HON. MORRIS K. UDALL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA, AND CHAIRMAN, COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

Mr. UDALL. Thank you, Mr. Chairman. I am deeply concerned about malnutrition on the part of the Budget Committee chairman and the staff for running these hearings through the lunch hour. I thank you for your kind words and however long I may take, I shall be brief, if you can figure that one out. [Laughter.]

Subject to your admonition, the Interior Committee this morning finished work on matters within our jurisdiction. A committee resolution was adopted. The figures are on their way here. I just wanted to come by and personally take a few minutes to talk about the priorities of my committee and my own personal priorities on these areas where we have jurisdiction. I will just hit three things quickly.

One is Indian programs. Of all the people in America, and Mr. Chairman, you are familiar probably more than most of us, but of all the people in the America, the most destitute and impoverished in the Nation are Indians for whom we have a special responsibility. You have heard the old statistics, 35 percent unemployment on the reservation, real unemployment ranges 50 to 80 percent. Half of the Indian families live on incomes below the national poverty standard. Forty percent of the Indian households are in a substandard unacceptable condition. In the critical field of health care, Indians lag behind the rest of the Nation by almost every indicator.

An observer of the health care on the Indian reservations put it rather dramatically when he said, Indian health is a generation behind that of U.S. non-Indian population. It is as though you and I went back to the medical care that was available 30 or 40 years ago. That is what we have for our Indian fellow citizens.

I would have thought in this situation the administration would seek budgetary help for the two agencies that deal with Indian problems. This is not the case, I must report. The President's budget request for 1987 proposes to impose a cut of $126 million on the Indian Health Service, a cut of nearly 16 percent. Indians are already dying at an unacceptable rate because of inadequate health care. This new cut would simply impose additional death sentences on them. That is for the Indian Health Service.

For the Bureau of Indian Affairs, which provides a broad range of programs and services, the cut is $35 million proposed. This is simply unacceptable, particularly when the cut is taken in light of severe cuts that have been made and are proposed for many other Federal social programs on which Indian tribes rely on for essential services.

It is not something you can dump on the States. The county governments do not see Indian problems as their problems. They see them as national problems. The States are not willing to pick up the slack.

We will be submitting recommendations to your committee, generally providing that the Bureau of Indian Affairs and Indian Health Service should be maintained at the fiscal year 1986 level after the Gramm-Rudman reduction.

Second, I want to hit just a minute on the Land and Water Conservation Fund. This was one of the great ideas of our time, one of the great conservation ideas of our time. The idea was we have all this oil land offshore and when we pump it out, it is going to be gone. The idea was let's take some of the royalties and revenues from those lands and take those oil resources and take that money and buy land that we will have for all time, for the enjoyment of people for parks. We split it up between the States and the Fed.

I have a printout of a park proposal of the land that has been purchased in my own congressional district, about an inch thick. There are little vest pocket parks and regional parks all over this country that were purchased with this Land and Water Conservation Fund money.

Starting with Jim Watt, the administration was determined to wreck or end this program. This year, once again, they propose for the National Park Service, $48 million last year and $50 million for grants to the States would be slashed by $83 million. The Park Service would have just $15 million instead of $50 million. The administration wants to rub salt in the wound by seeking a rescission of almost $20 million in fiscal year 1986 land acquisition funds.

We have a backlog of $500 million of land that the United States has sublet to land owners. This belongs to the National Park and we are purchasing it, but we can't get the administration to put up the money. It is wrong.

I urge the committee to stand with us in restoring this great idea of the Land and Water Conservation Fund.

Finally, we have jurisdiction over our territories and the Commonwealth of Puerto Rico. We held hearings on the potential impact of the President's budget for the 3.5 million people of the insular areas. The committee's reaction to all of this has been uniform. We have a bipartisan recommendation that I would like to outline.

The most important would rectify serious policy problems and inequities which were uniquely created for the insular areas by Gramm-Rudman and other laws as well as the President's budget. Throughout this century, the Federal Government has collected taxes, custom duties and fees, for Puerto Rico, Guam, and the Virgin Islands, and transferred them to the insular governments.

The Director of OMB told your counterpart committee in the other body that similar funds were exempted from sequestration and these funds should have been as well; $16.5 million in sequestered insular collections should be made up to preserve long respected and carefully constructed insular relationships. You will hear more on that from Congressman de Lugo.

The people of Puerto Rico were taken out of the Food Stamps Program in 1981. The Commonwealth was given a block grant to set up a local program. That grant is now worth only about three-quarters as much as food stamps would be.

The Interior Department has a number of obligations, including a debt to the Guam Power Authority that is covered in my statement.

I would hope, in conclusion, that the committee will give attention to our recommendations within the guidelines and the total

amount, and I hope that special attention will be given to these matters.

I thank you, Mr. Chairman.

[Testimony resumes on p. 675.]

[The prepared statement of Mr. Udall follows:]

Prepared Statement of Hon. Morris K. Udall

Mr. Chairman, I welcome the opportunity to appear before the Committee on the Budget today in order to bring to your attention some of the most serious problems that I have found in the budget as presented by this administration for the programs under my Committee's jurisdiction.

The Administration has asked us to radically change our priorities so that it can pay for its priority programs.

The Administration asks us to reduce programs for American Indians, and other Native peoples for whose well-being we are responsible.

As you and your Committee members have made clear in your visits to some of the great cities of our nation, it is unfair to keep sacrificing their programs to the misguided priorities of this administration.

We who represent the peoples who live in the small towns, the reservations, and the islands stand with the mayors of our cities in attempting to redress this radical imbalance of our nation's priorities. Finally, as a people we believe that Teddy Roosevelt was right to set aside unique lands for national parks, and we intend to continue to do so.

Now I want to address specific problems I have with respect to Indian programs, Territories and the Land and Water Conservation Fund.

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INDIAN PROGRAMS

Mr. Chairman, the programs of the Bureau of Indian Affairs, except for education, and the programs of the Indian Health Service are within the jurisdiction of my Committee. We need only look at the President's budget request for these two agencies to see the basic unfairness of the Administration's budget.

The United States has a special, trust responsibility for the Indian tribes and their members. The Indian people are almost solely reliant upon the programs and services made available by these two agencies. Yet despite this special responsibility, our Indian citizens remain the most destitute and impoverished in the Nation.

Official unemployment on the reservation is about 35% and real unemployment ranges from 50% to 80%.

Nearly half of the Indian families live on incomes below the national poverty standard.

Nearly 40% of the Indian housing is in a substandard, unacceptable condition.

In the critical field of health care and status, Indians lag behind the rest of the Nation by almost every indicator. In the words of the recent report of OTA on Indian health, "... Indian health is a generation behind that of the U.S. non-Indian population ...."

Mr. Chairman, even in this era of Gramm-Rudman and high Federal deficits, we might expect the Administration to seek budget

increases for these two agencies to enable the United States to meet its unique responsibility to Indian people or, at least, to maintain current program effort.

But, unhappily, I must report to your Committee that this is not the case.

The President's FY 1987 budget request proposes to impose a $126,000,000 cut on the Indian Health Service, a cut of nearly 16%. Mr Chairman, Indian people in this country are already dying at unacceptable rates because of inadequate health care. This new cut would simply impose additional death sentences on them.

For the Bureau of Indian Affairs, which provides a broad range of programs and services for Indian people, the Adminstration is proposing a cut from FY 1986 of approximately $35,000,000. With poverty a way of life on Indian reservations, this kind of cut is unacceptable to my Committee. This is particularly true when the cut is taken in light of severe cuts which have been made and are proposed for the many other Federal social programs upon which Indian tribes rely for essential services.

Mr. Chairman, my Committee will be submitting recommendations to your Committee on the various programs within its jurisdiction. Those recommendations will generally provide that the BIA and IHS budgets should be maintained at the FY 1986 level after the Gramm-Rudman reduction.

I strongly urge your Committee to accept these recommendations on Indian programs in your deliberations.

Land and Water Conservation Fund

Mr. Chairman, for five long years now my Committee, with the strong support of the Appropriations Committee and the House, has fought off the misguided efforts of the Reagan Administration to gut or to misuse the Land and Water Conservation Fund. One of Secretary Watt's highest priorities during his lamentable tenure was to stop federal, state and local acquisition and development and to turn the Fund into and operation and maintenance account for the Park Service.

If my Committee has learned little else over the years, it is the foolishness of this approach. Not only do the Amerian people overwhelmingly support the Fund's activities, it also is abundantly clear that failure to finance the Fund only pushes off onto future budgets the higher costs of today's inaction--whether it be through escalating land acquisition costs, unfinished projects in community after community that must be finished at a later date or through damage to resources that must be mitigated at great expense.

We in the House defeated Mr. Watt's effort and have defeated the proposals of each subsequent Secretary to starve the Land and Water Conservation Fund into ineffectiveness. The pressures of Gramm-Rudman must not now be used as the excuse to achieve this extremely short-sighted piece of the Administration agenda.

The Administration's proposal this year is, once again, unrea-

listic and unacceptable.

Last year's appropriation to the Park Service of $48 million for land acquisition and $50 million for grants to the states would be slashed by $83 million. The Park Service would have just $15 million for land acquisition. The Administration wants to rub salt in that wound by seeking a rescission of almost $20 million in FY '86 land acquisition funds and $36 million in state grants. The Fish and Wildlife Service is reduced from approximately $39 to $1.5 million, the Forest Service drops from $27 million to just over $3 million, and the Bureau of Land Management gets nothing at all.

This is Secretary Watt's old moratorium wine in a new bottle. It was wrong then, and it is wrong now. Gramm-Rudman must not be used as the excuse to destroy the Land and Water Conservation Fund. The price for our success in defeating the Administration's worst intentions have been occasional moratoria and dramatically reduced levels this year for all aspects of the Fund divided as follows: $80 million for the Park Service, $20 million for the Fish and Wildlife Service, $25 million for the Forest Service, $2 million for the Bureau of Land Management and $35 million for state grants. This is a reasonable and realistic funding level that acknowleges current fiscal realities without adopting the radical and needlessly destructive approach of the Reagan Administration.

INSULAR AFFAIRS

The full Interior and Insular Affairs Committee has jurisdiction over matters concerning our five territories and commonwealths. So, hearings were held on the potential impact of the President's budget on perhaps the least powerful and most needy of our fellow Americans, the 3.5 million people of the insular areas.

The administration's proposals were explained. Insular executive and legislative leaders commented upon them and identified needs which they would not meet.

The Committee's reaction was uniform. It resulted in bipartisan recommendations which I would like to outline.

The most important would rectify serious policy problems and inequities which were uniquely created for the insular areas by Gramm-Rudman and other laws as well as the President's budget.

Throughout this century, the federal government has collected taxes, customs duties, and fees for Puerto Rico, Guam, and the Virgin Islands and transferred them to the insular governments. As the Director of O.M.B. told your counterpart committee in the other body recently, these funds only appear in the budget as an administrative convenience and similar funds were exempt from sequestration.

$16.5 million in insular collections sequestered by GAO should be made up to preserve long-respected and carefully constructed insular relationships.

The hungry in Puerto Rico were taken out of the Food Stamps Program in 1981 and the commonwealth was given a block grant to set up a local program. The grant is now worth only about three-quarters as much as food stamps would be.

The hungry Americans of Puerto Rico deserve just as much nutrition assistance as hungry Americans elsewhere in the nation, including the other insular areas. Congress partially recognized this in last year's farm bill by providing a $27.7 million 1987 increase in the grant.

The president's proposal to repeal the increase should be ignored. An additional $4.9 million cut from the current grant should be made up.

The Interior Department pays interest costs above seven percent on the federal debt of the Guam Power Authority. The sequestration of $360,000 should be made up to preserve the utility's financial position. The joint power system serves military as well as civilian purposes.

The President's proposal to substantially increase capital improvements in the Northern Mariana Islands seems to make little sense in the context of his proposal to decrease funding similar needs in our two other Pacific insular areas: Guam and American Samoa.

The Committee agrees with the need for infrastructure in the commonwealth but would increase construction in the two territories by $4.3 million. This is just barely more than is spent now.

We also do not think that technical assistance to insular governments should be cut more than in half. Technical assistance is one of the most effective and least costly forms of federal assistance to insular areas.

We have recommended $550,000 more than the President in Interior Department technical assistance.

We would maintain special Energy Department technical assistance to lessen the costly, almost total dependence our islands have on imported oil. $475,000 is recommended to develop their indigenous, renewable resources.

Finally, we continue to agree with the President and Chairman Gray that one of the best ways to provide technical assistance to our Eastern Caribbean neighbors is through the Virgin Islands. $1.2 million is recommended to be added for the U.S. Information Agency, as would be authorized by expected Senate action soon on a House-passed bill.

With per capita incomes a fraction of the States and unemployment rates up to several times higher, the insular areas are the among the most needy jurisdictions. Without voting representation or the vote for President, they are the least powerful.

We are obliged to do what we can to meet basic needs in our Caribbean and Pacific insular borders. A recent study demonstrating that Gramm-Rudman cuts would hit the insular areas far harder than the States indicates that we need to do more than we have in the past.

I ask that you pay particular attention to our recommendations for the insular areas. They are small but are essential to many of our fellow Americans.

The CHAIRMAN. Thank you, Congressman Udall, for your testimony and particularly your continued dedication to your responsibilities as Chair of a very important committee that deals with some often left out items and concerns in our Nation's priorities.

At this time, the Chair will recognize the gentleman from the Virgin Islands, Congressman de Lugo. I would inform Chairman Udall there is a vote on the floor. We will submit any questions to you, Congressman Udall, that we may have, to follow up on your testimony.

Mr. UDALL. Thank you. Good luck in your important endeavors here.

The CHAIRMAN. Thank you. With your help, we are going to do it again like we did last year. Thank you, Chairman Udall. Congressman de Lugo.

STATEMENT OF HON. RON DE LUGO, A REPRESENTATIVE IN CONGRESS FROM THE VIRGIN ISLANDS

Mr. DE LUGO. Thank you very much, Mr. Chairman. I would like to support the statement of Chairman Udall. I want to commend Chairman Udall for the leadership he has shown on the Interior Committee, his committee, and particularly in being able to bring in the committee's budget below the Gramm-Rudman cuts, and at the same time in the insular areas that is the territories and commonwealths of the United States, to get unanimous support for the budget recommendations.

The provisions for the U.S. territories and commonwealths are supported by both the Republican members and the Democratic members. They were worked out. There was unanimity in the budgets of the both the Republicans and the Democrats and of course the budget was passed as Chairman Udall said this morning.

I want to thank Don Young and Bob Lagomarsino for the leadership they showed on their side in addressing these issues for the territories.

Chairman Udall alluded to the excise taxes for the territories. Under the 1984 Tax Act, the $2 increase in the excise tax on distilled spirits was not returned to the Virgin Islands. The increased

cost of liquor has had its impact on sales, a loss which the Virgin Islands cannot compensate for through the increased tax. Additionally, these excise taxes have been reduced by the Gramm-Rudmann sequester. This is a matter that it is imperative to address. I want to commend the Interior Committee for finding a way of including full return to the Virgin Islands of excise taxes collected on rum within the spirit of Gramm-Rudman. I urge very strongly that your committee, Mr. Chairman, restore these funds to the Virgin Islands, and all of the section 30 of the Guam Organic Act funds to that territory.

The budget proposal today from the Interior Committee provides for the return of this money as it has historically been done. I would urge your committee support this proposal.

[The prepared statement of Mr. de Lugo follows:]

PREPARED STATEMENT OF HON. RON DE LUGO

I appreciate this opportunity to bring to your attention budget requests specific to the U.S. Virgin Islands. At a time when each committee of the House has struggled to meet its obligation to reduce Federal spending, I am assured by the fact that the merit of the items I intend to discuss have been endorsed by the committee with jurisdiction over the territories, the Committee on Interior and Insular Affairs. I hope they will benefit from the same bipartisan support in this committee. I commend Chairman Udall for his leadership in identifying the essential budgetary issues facing each of the U.S. insular areas and prioritizing the Federal assistance available to meet them. His commitment to the insular areas is both reassuring and needed. I also thank ranking Republican Members Don Young, Manual Lujan and, particularly, Robert Lagomarsino for their support.

The revised Organic Act of the Virgin Islands is the Federal law which establishes the premises of this country's relationship with the territory of the Virgin Islands. A major component of that act is the permanent financial assistance provided to the territory through advanced payment of United States excise tax collections on products of the islands. The most significant of these collections are the excise taxes on rum. This tax was imposed on rum entering from the Virgin Islands, and Puerto Rico, as a means of equalizing the costs vis-a-vis mainland distillers. From its inception, this equalizing tariff was returned to the territory. There were two prevailing theories for the returns: Excise taxes provide an ideal source for meeting the Federal objective of promoting economic development in the territories because they are tied to local production; and, Federal taxation of territorial inhabitants suggests taxation without representation which is avoided by returning the assessment to the local government.

Over the past four years, the Virgin Islands have experienced considerable cuts in capital improvement assistance. Such assistance has been central to the infrastructure development lacking in territorial economies. Meanwhile, the territory faces demands by the Environmental Protection Agency to build sewage treatment facilities, there is overcrowding in the schools, and I could go on. As these items percolate, the Virgin Islands Government has had to be increasingly creative in its solutions. This has, for the most part, meant that the local government has had to issue bonds, bonds backed by the one fund available for that purpose: the excise taxes collected on rum.

Gramm-Rudman has been interpreted as covering the excise tax fund. For fiscal year 1986, the territory stands to lose 1.3 million dollars in sequestered excise tax returns. Yet, the revenues involved constitute a Federal obligation to the territory prior to their collection. Thus, transfer of these payments to alleviate the Federal deficit would constitute a transfer of funds from the territorial government to the Federal Government.

The Director of the Office of Management and Budget stated in testimony before the Senate Budget Committee that the rum excise funds "appear in the budget as an incidental matter for convenience of administration rather than as a means of resource allocation." Congress recognized and exempted most of this type of account from sequestration, but failed to do so for the Virgin Islands rum fund, and similar territorial accounts. I ask the committee to budget for return to the Virgin Islands of all excise taxes sequestered.

The committee is in recess for 5 minutes.

[After recess.]

The CHAIRMAN. The committee will now reconvene.

Congressman Byron Dorgan, we welcome you to the Budget Committee hearings. As we have said to all of our witnesses, your testimony in its entirety will be submitted for the record. We hope that you will be able to summarize your testimony and highlight the major points as we look at ways to reduce the deficit of our budget and make the right choices. Congressman Dorgan, we invite you to proceed.

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. Thank you, Mr. Chairman.

I do intend to submit a complete statement for the record and would like it printed in its entirety. I will summarize.

I wanted to be here today simply to describe to you my disappointment with the President's budget and tell you on the Budget Committee what I think we ought to consider in order to extricate ourselves from this fiscal policy mess.

The problem is, this town responds to leadership, and there isn't any leadership at the moment. You know, the budget that the President sent to Congress is not considered seriously by anyone. You could go to the floor of the House and ask Republicans, Would you vote for this up or down—that is, the President's budget—and they won't vote for it, because it's not a document that's crafted with any kind of a consensus in mind. It's a radical document that basically misunderstands what the priorities should be in this country, and I think we, in the absence of leadership from the President, are going to have to craft something that does represent the right kind of investment, the right path to deficit reduction for the future of this country.

There are a number of things in the budget that I am distressed about.

One, at a time when we have literally thrown money at defense, and the evidence suggests that we're paying $400 for claw hammers, $7,600 for coffee pots, $400 for ashtrays and so on, we see in this budget another request for another 12 percent increase in defense. Now that's on top of a $150 billion increase in defense that we've had in the last 5 years—one $150 billion increase in the past 5 years, another 12 percent increase this year, a 41 percent increase between now and 1991.

When is it going to stop? Are we going to have money left for anything else? I don't quite understand a President who professes to be a conservative and in favor of balanced budgets, who increases defense spending $150 billion by his request in 5 years, and now wants more increases, but will not propose revenues to pay for it or any sure program to ensure that it is spent wisely and well.

So looking at his budget generally, I have some difficulties with his proposed increase in defense with no additional revenues to pay for it. I also object to his proposed 12 percent increase in foreign aid, most of which is not aid that can be eaten or aid that can be injected in the form of vaccine or ingested in the form of a pill that

Prior to Gramm-Rudman, the historical return of all of the excise taxes collected on rum was undermined by the 1984 Tax Act. The act increased the excise tax on rum and other distilled spirits by two dollars per proof gallon. But, for the first time, the act also prohibited the cover over of that increase to the Virgin Islands, and Puerto Rico. The result was the reduced sales which occur when there is an increase in the cost of liquor, without the benefit of the tax increase. According to the President's budget, over five years the excise taxes returned to the Virgin Islands will fall from 40 million dollars to 25 million dollars.

I ask the committee to include the cover over of the increased collections on rum produced in the Virgin Islands to this territory. The President's budget estimates that 26 million dollars in excise taxes are to be returned to the Virgin Islands in fiscal year 1987. My request is that the 1.3 million sequestered under Gramm-Rudman and the 5 million excluded under the 1984 Tax Act also be returned, bringing the cover under that account to 32.3 million dollars.

Under his request for administration of the territories, the President has included 2.9 million dollars for construction of water lines in the Virgin Islands for fiscal year 1987. This would contribute much needed assistance to the ongoing problem of leakage in the territory's water distribution system. The Virgin Islands has invested considerable funds in desalination projects to alleviate what were chronic water shortages. Much of the water, however, is lost due to leaks in a forty year old water system plagued with rust. I ask the committee to include this request in its budget report.

I thank the committee for this consideration, and will be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much, Congressman de Lugo. You have been very eloquent in the House of Representatives in representing the Virgin Islands and making the special needs and concerns known to Congress. Often as we make laws here in the Congress, we do not take into consideration those special needs.

I want to thank you for your testimony. We must also recognize that laws Congress makes don't apply just to Philadelphia or Los Angeles or Maine or Texas, but also to the U.S. Virgin Islands. There are some special requirements.

The committee will be taking into careful consideration these concerns as we put together the budget for fiscal year 1987 and as we attempt to avoid the sequestration effects of Gramm-Rudman. It is our hope and our intention to reduce spending to a bona fide level of $144 billion so that we will not kick in the sequestration effect of Gramm-Rudman. Therefore, some of the intended consequences that Members did not think about when they supported Gramm-Rudman would not fall most heavily upon the Virgin Islands.

I want to thank you, Congressman de Lugo, for your testimony. I also want to thank you for your continued voice here in the House in support of not simply the Virgin Islands, but the territories of the United States of America, which are a part of this Nation.

Mr. DE LUGO. Thank you very much, Mr. Chairman. On behalf of all the territories, I personally want to thank you for the Virgin Islands. You have been tremendously helpful to me here in the Congress and to the people of the Virgin Islands. I also know you have been sensitive to the needs of all of our offshore areas. I thank you for that and for the opportunity of testifying before your committee today.

The CHAIRMAN. Thank you very much, Congressman de Lugo.

The committee will recess while there is a vote being taken. We will resume in approximately 5 minutes with testimony from Congressman Byron Dorgan and also Chairman Dan Rostenkowski, chairman of the Ways and Means Committee.

will help those who are malnourished or sick. Most of it is military aid. There seems to be a preoccupation with things that will explode. If you've got something that will explode, you'll send it around the world. It doesn't matter how much it costs. We've got plenty of that, and yet when it comes to feeding the hungry, to providing medicine to the sick, to teaching for the illiterate around the world, we seem to be short.

I'd like to point specifically, Mr. Chairman, to the military assistance program in this budget. It's a program that I've been on the floor about in past Congresses, and once again, the President proposes in the military assistance portion, the MAP portion of foreign aid, a 33-percent increase. Now this comes at a time when the President is saying to America, "We've got to tighten our belt. We don't have enough." But a 33-percent increase in military assistance programs is all right. In some cases, we're on both sides of a foreign conflict. I mean, somehow that doesn't make much sense to me, and I don't think it makes sense to most other people serving in Congress either.

An increase in military sales also troubles me. Now the first was MAP; the second is military sales. Substantial increases. At the same time that we want to provide either low interest or no interest money for military sales which will be dramatically increased in this foreign aid proposal, we're saying to farmers, Well, we're not sure we've got enough money to make you operating loans to buy feed, seed, and fertilizer for spring planting or to feed your cattle. Again, there is something, I think, that is fundamentally wrong with that.

On the domestic side of the budget, you know, we had some problems. We threw some money at some programs, wasted some money, and we're trying to retrench and find out what we need and how to run them effectively. But to suggest that all spending on the military is somehow strengthening America, but all spending on the domestic side is waste, I think is kind of foolish, and that seems to be the prevailing notion from the White House. They're saying, let's give another $100 million to the Contra soldiers in the hills between Nicaragua and Honduras. Let's give millions more to Pakistan and others, and increase foreign aid 12 percent.

In my home State, we have four Indian reservations. Most Indian programs are proposed to be cut by 20 percent, under Gramm-Rudman and we had a call from an elderly woman on an Indian reservation just this week, who was melting snow for water and burning clothes for heat. I don't quite understand priorities that say it's fine to be throwing money at Contra soldiers, to be radically increasing MAP programs, and to be cutting essential needs here in this country.

Aside from the foolishness of what I think are the priorities in the President's budget, I would like not only to encourage us to reevaluate what has a priority, I'd like to suggest about seven steps that I think can and should be taken by us to resolve the Federal deficit.

First, in the tax area, there are two principal concerns I have. One, I think the middle American people on a W-2 form, who don't have any flexibility, they're paying a pretty stiff tax. I don't think

we need a general tax increase of an income tax nature. I think there are a couple things we can do in the income tax area, however, to get anywhere from $60 to $90 billion a year.

We lose about $100 billion that should be paid that isn't to the IRS. Better enforcement can get some of that money. Even if only a third of it is achieved, that's a $30 billion increase in revenues. Not only are we not better enforcing the laws, but audits in the IRS have gone from 3 percent of returns filed to about 1.5 percent of returns filed because of decreases in the labor force at the IRS. So beef up tax enforcement.

The second main tax concern is to close tax loopholes; $120 billion in corporate tax loopholes alone. We could close some of those, and, I think, use some of that money, instead of driving down rates, to drive down the deficit.

Third, I think we ought to require pay as you go. Let's tell this President, and let's tell Republicans and Democrats, "You want to have some new spending, you've got to pay for it. Propose the revenue source."

Fourth, I think budget restraint is necessary. I agree with the President, we need to restrain spending, but we need to make the right kind of priority choices. You can't support 12 percent increases in defense, 12 percent increases in foreign aid, at the same time that we're cutting almost everything here at home that's essential for people.

Fifth, let's remove Social Security from the unified Federal budget. It's a dedicated trust fund that pays for Social Security. It's running a surplus at the moment. The Social Security expenditures ought to relate to the trust fund income. It ought not have anything to do with the unified Federal budget or paying for other programs.

Sixth, I think that the Grace Commission had some good recommendations. There were some that were a little cockeyed, but basically they had some pretty good recommendations in procurement reform and other areas, particularly with respect to military spending. We need to get about the business of making sure that the best of those recommendations from the Grace Commission are fully implemented.

And finally, I think it's important for us who are involved in fiscal policy issues to try to put the bite on the Federal Reserve Board to say that if we adopt and develop a multiphased program that brings down this deficit from a fiscal policy standpoint, we want the Federal Reserve Board to work on monetary policy in a way that will bring targets for interest rates down 1 or 2 percent at the same time. That could make a dramatic improvement in the economy. It could have, I think, also a very beneficial impact on the Federal deficit.

Those are the principal areas of concern that I have, Mr. Chairman. I have outlined them in much greater detail in the statement. I know that the committee is busy and intends to hear from a lot of Members of Congress, and I would like, then, to wrap this up.

But in conclusion, I'd like to point to an editorial that appeared in the Cando, ND, newspaper, written by Blanche Dennison. It's called "The 1987 Budget: A Rural Disaster." It's a very thoughtful editorial in which Blanche Dennison talks about what we're doing

in this country of ours. She doesn't say it quite this way, but think of it in terms of a group of historians 100 years from now, trying to analyze what we were about and what we were thinking back in this time period and what persuaded us to make the kind of spending choices and the kind of investments we've made. They're going to be a puzzled bunch of historians, unless we turn the corner and start doing the right things for the future of this country.

So I want to thank you for your courtesy, Mr. Chairman. I will submit my entire statement for the record.

[The prepared statement of Mr. Dorgan follows:]

PREPARED STATEMENT OF HON. BYRON L. DORGAN

MR. CHAIRMAN: There's been a lot of loose talk in the op-ed pages lately that budget deficits don't matter. I know that you, Mr. Chairman, and members of this Committee don't share that view. And neither do I. Nor do we think that the President's budget priorities are set in concrete. So I appreciate the opportunity to testify on steps to balance the federal budget and how to realign budget priorities.

A DISMAL RECORD

The President sent his budget to Congress with a great deal of fanfare and flourish.

But it's a budget of missed opportunities and misplaced priorities. This reportedly conservative President misses the opportunity to take a big bite out of the federal deficit for fiscal year 1987. He calls for a $144 billion deficit, a figure many budget experts regard as a drastic understatement, and more spending than any president in history. He does this even as he pleads for a Constitutional amendment to prevent other chief executives from doing the same thing. Missed opportunities.

The White House says let's throw our money away on things we don't need like $4 billion for Star Wars and dry up the funds for services we do need like a strong farm program. President Reagan has simply not heard the message of the American people that they don't support throwing money at defense while we shortchange higher education. Misplaced priorities.

If the American people are confused by the contradiction between the President's budget rhetoric and his FY 1987 budget reality, they have a right to be. But they shouldn't be surprised.

I have attached a table prepared by the Congressional Research Service which shows that Ronald Reagan has consistently sent up to Congress budgets bleeding with red ink. The total deficits in the combined FY 1982-87 budget requests total $827.8 billion. What is even more astounding, given the President's longstanding promise to put the federal fiscal house in order, is that actual deficits between FY 1982-1987 are estimated at $1.04 TRILLION (assuming the Gramm-Rudman target of $144 billion for next year.)

Not that Congress should pat itself on the back. But the record does show that Congress has approved budget resolutions with $20 billion less in red ink than the budget requests during the Reagan Administration. We also know that for the last forty years, Congress has only rarely appropriated more money than President's have requested.

DAMPING UP THE RED INK

So if the President's plan is to double the national debt every five years, what should Congress do.

One shorthand suggestion is to freeze spending and let federal revenues grow as estimated in the FY 87 budget request. With total outlays for FY 1986 of $979 billion and total revenues estimated for FY 89 of $996 billion, we would actually achieve a budget surplus by then.

Naturally, this doesn't allow for the growth in population or of eligible recipients. But I make the point to show what spending restraint plus increased revenues can do. I suggest that this makes much more sense than the snake oil of Gramm-Rudman.

More realistically, I would like to suggest seven steps for balancing the budget.

1. Beef up enforcement of our tax laws to collect from those who refuse to pay. Every dollar the Internal Revenue Service spends on collection and enforcement yields $5 to $10 in revenue. The President makes a start in his budget request by

strengthening tax audit and tax shelter programs. But we need to do more if we would recover the massive $90 billion in uncollected tax revenues each year.

2. Require increases in revenue to pay for any spending increases by the President or Congress from one year to the next. Let's put the government on a "pay as you go" basis, as members of this committee have long urged. For five years, this President has used budget authority as a charge card for the most massive defense buildup in our peacetime history. If we need this kind of defense, then let's pay for it. If we don't, then let's quit trying to stop the red menace with red ink. It's remarkable that the 1987 budget request uses only 17 pages to show how to raise revenue, but takes 426 pages to show how to spend it.

3. Close tax loopholes and use the revenues to pay for deficit reduction only. It may be old news, but it is still relevant news that 50 of the nation's largest corporations paid no net federal taxes from 1981 to 1984. Of these, 48 had refunds totaling $2.4 billion. Similarly, 30,000 taxpayers with incomes over $250,000 paid little or no taxes in 1983. We must raze these billionaire and millionaire tax shelters.

4. Trim the federal budget in every area, including foreign aid and defense. How the President can justify a 6% cut in all domestic programs when he proposes a 12% growth in foreign aid absolutely escapes me. No less is true of a five year defense plan with a final price tag 42% higher than last year.

5. Remove the Social Security System from the unified budget. We should advance the date for establishing separate trust funds to FY 1987 and guarantee that these dedicated revenues from working people won't be tampered with for deficit reduction. To keep Social Security itself on a solvent basis, we should then ensure that trust fund expenditures don't exceed income.

6. Adopt and implement many of the management reforms proposed by the Grace Commission. While this is a keystone of the Reagan Revolution, not much war has been waged yet. The military procurement system needs a wholesale retooling. Get rid of the $640 toilet seats and the system which spawns such outrages in the 44% of the defense budget consumed by procurement and spare parts. We need to put some teeth into contract sanctions so the General Dynamics of the nation don't keep ripping off the taxpayer and undercutting our security. We have a platter of unfinished business like shutting the revolving door between military service and defense contracting before us already.

Nor should we overlook domestic waste and fraud, where our knives have also been very dull. A recent report by the Inspector General of GAO revealed that weaknesses in government accounting "have made outright fraud more feasible." A General Services Administration study also warned that the agency suffers from such mismanagement that top officials "could earn a million dollars a year or more through fraudulent means." Let's make sure that agency Inspectors General growl like junk yard dogs instead of prowling like pussy cats.

7. Require the Federal Reserve Board to adopt a policy of moderating benchmark interest rates by 1 or 2% in concert with reductions in federal deficits. We can't put the entire burden of economic growth on fiscal policy. The Fed must also play a role.

REALIGNING FEDERAL PRIORITIES

As I mentioned, I think the President's budget request turns investment priorities on their collective head. For one thing, the budget reveals a fundamental misunderstanding of national strength. Every army moves forward on its belly, but this budget makes a mockery of American agriculture. It would cut price supports 20% when family farmers face the worst farm crisis since the Great Depression. It would champion a 35% cut in Farmers Home Administration and Rural Electrification Administration loan programs. It would dismantle the federal grain and meat inspection services and gut the farm extension service. These programs have helped to make America's farmers its economic all stars. We need to remember that high-tech soldiers without food are tin soldiers.

I don't advocate throwing money at farm programs any more than I do at defense. I am working with other farm state members on a package of reforms to the Farm bill which will layer in a strong price support program for the farmers who need it, for no more money than the present wasteful and indiscriminating system. But neither do I believe we can justify a 12% rise in a defense budget loaded down with a 75% increase in Star Wars and a 33-fold boost for ASAT programs frozen by Congress.

I am equally disturbed by President Reagan's foreign aid budget. To repeat, he wants to sell a package with a 12% increase in foreign aid appropriations and a 6% cut in domestic programs. I'm not here to say that all foreign aid is bad or that all

social programs are sacrosanct. But the priorities are all mixed up. One of the fastest growing programs in the federal budget is the Military Assistance Program (MAP), which the President eyes for another 33% increase in FY 1987. This occurs in the face of evidence in Haiti and the Philippines that all the military aid in the world can't prop up dictators who don't meet their people's needs. While Africa continues to face critical shortages in food, medicine, and transport aid, the Administration plans to cut Food for Peace and UNICEF—two of the most useful and cost-effective programs we support.

Nor can I understand the Administration's on-again, off-again support for the International Fund for Agriculture Development (IFAD). More than any other multilateral agency, it can boast a proven track record of building private enterprise, on a shoe-string budget, in even socialist nations. Here's a winner that deserves our strongest support.

But then the Administration wants to keep making low cost loans to every foreign government that will sign up, while it creams loan programs for family farmers. The Administration wants a $700 million—or 14%—increase for Foreign Military Sales. All of these carry either no interest or very low interest. But the budget calls for a 35% cut in farm-related credit and wants credit-strapped farmers to go into marketplace at commercial rates. Remarkably, farmers are bad risks to the government, but foreign governments are not.

It just so happens that foreign governments are now officially late 90 days or more on $3.3 billion in principal and interest payments. Brazil is late on $57 million, Cambodia on $49 million, Egypt on $313 million, Iran on $123 million, Jordan on $48 million, Poland on $1.6 billion. We can't make 5% REA loans, but we can hold the paper for 4.5% notes for a communist government. These are strange priorities.

Likewise, the Administration has strained to send generous foreign aid and our own armed forces to aid allied nations. While we spend 40% of our military budget to defend NATO and six times the comparable amount for defense as Japan, we are losing the shirts off our back in international trade. With trade deficits soaring over $100 billion each year can we any longer afford to finance effectively the R&D of our major trading partners and competitors?

When it comes to treaty commitments closer to home, it's another story with the White House. I recently received a call from a tribal council member in North Dakota. He asked me what in God's name we were doing in Washington. "How can you send another $100 million to the contras, millions more to Pakistan, and increase foreign aid 12% when Indian programs are going to be cut 20%. The same day I got a call from the same reservation from elderly woman who was melting snow for water and burning clothes to stay warm.

In conclusion, Mr. Chairman, I could talk about other priorities. Making needed investments in student aid. Ensuring adequate health care for the elderly. Strengthening our technology for alternative fuels. Let me simply say that we must remember what made this country the strongest nation in the world and keep making balanced investments in a defense that works, in foreign aid that builds genuine partnerships, in farm programs which form the bedrock of our security, and in social programs which "provide for the domestic welfare."

Let me reiterate, too, that we won't get rid of budget deficits unless we put all on-budget spending on the table and tap the $90 billion in uncollected revenues and billions more in senseless tax shelters. Unless we do, each American taxpayer will be in deep trouble. Right now, the taxpayer earning the median income pays $700 a year, or 1½ weeks of salary just to pay off interest on the national debt. Clearly, deficits do matter.

Thank you for hearing my suggestions on the Fiscal Year 1987 budget. I would be glad to answer any questions you may have.

TABLE 1. COMPARISON OF PRESIDENTIAL, CONGRESSIONAL, AND ACTUAL LEVELS OF BUDGET AGGREGATES: FISCAL YEARS 1982–87

[In billions of dollars] [1]

Budget aggregate and fiscal year	President's original request	First budget resolution	Actual level
Budget authority:			
1982	772.4	770.9	779.9
1983	801.9	822.4	866.7
1984	900.1	919.5	927.4

TABLE 1. COMPARISON OF PRESIDENTIAL, CONGRESSIONAL, AND ACTUAL LEVELS OF BUDGET AGGREGATES: FISCAL YEARS 1982–87—Continued

[In billions of dollars] [1]

Budget aggregate and fiscal year	President's original request	First budget resolution	Actual level
1985	1,006.5	1,021.4	1,074.1
1986	1,052.4	1,069.7	[2] 1,058.7
1987	1,102.0	NA	NA
Outlays:			
1982	695.3	695.5	728.4
1983	757.6	769.8	796.0
1984	848.5	849.5	841.8
1985	925.5	932.1	946.3
1986	972.2	967.6	[2] 979.9
1987	994.0	NA	NA
Revenues:			
1982	650.3	657.8	617.8
1983	666.1	665.9	600.6
1984	659.7	679.6	666.5
1985	745.1	750.9	734.1
1986	793.7	795.7	[2] 777.1
1987	850.4	NA	NA
Deficit:			
1982	45.0	37.7	110.6
1983	91.5	103.9	195.4
1984	188.8	169.9	175.4
1985	180.4	181.2	212.3
1986	178.5	171.9	[2]202.8
1987	143.6	NA	NA
Total 1982–86	684.2	664.6	[3] 896.5
Total 1982–87	827.8	NA	[3] 1,040.5

[1] Fiscal year 1982–1986 figures exclude off-budget transactions. For fiscal year 1987, agencies formerly off-budget were returned to the budget and are reflected in the figures; also, Social Security [OASDI], formerly on-budget, was placed off-budget but is reflected in the figures in order to provide for a consistent comparison.

"President's original request" refers to President Reagan's recommendations submitted in January or February before the start of the fiscal year. For fiscal year 1982, the figures reflect the Reagan revision of the final Carter budget.

"First budget resolution" refers to the concurrent resolution on the budget scheduled to be adopted by Congress by the May 15 preceding the start of the fiscal year. Fiscal year 1984 figures exclude reserve amounts. Congress has not yet acted on a budget resolution for fiscal year 1987.

In the case of the "actual" levels for fiscal year 1986, the revised estimates in the President's fiscal year 1987 budget are used.

Revenue and outlay figures may not reconcile precisely with deficit figures due to rounding.

[2] Estimate.

[3] Estimate with Gramm-Rudman.

Sources: Budget of the U.S. Government, fiscal year 1982, Budget revisions (March 1981); Budget of the U.S. Government, fiscal years 1983–1987; and conference reports on first budget resolutions, fiscal years 1982–1986.

The CHAIRMAN. Congressman Dorgan, we certainly want to thank you for your testimony. We look forward to having the rest of it submitted for the record. And let me also thank you for your insights with regard to the priorities of this budget and how it affects the agricultural sector of America.

I think it is very interesting that you have brought out the fact that in foreign assistance, the President is calling for a $900 million increase, an increase in foreign military sales, security programs, of almost $1 billion, while in agricultural research and service, which is a prime way to build for future growth in the agricultural sector, there is a 20 percent cut of $350 million, and that doesn't even go into the programs like the CCC or the various crop programs. And certainly I share with you that concern at a time when our farmers are in a distressed situation because of the fiscal policies of the administration, which have distorted the international marketplace, which is so vital to them.

Thank you very much, Congressman Dorgan, for your testimony.

At this time, the Chair calls to the witness table the distinguished chairman of the House Ways and Means Committee, the gentleman from Illinois, Mr. Rostenkowski.

Chairman Rostenkowski, welcome to the Budget Committee. You play a very vital role in the doings of the House of Representatives and in the budget process. Before you begin, let me take this opportunity to thank you and your committee for the cooperation it has given the Budget Committee. We have three outstanding members of the Ways and Means Committee who are represented on the Budget Committee: Congressman Tom Downey, a senior ranking member of the Budget Committee and a member of the Ways and Means Committee; Congressman Martin Russo, and also Congressman Ed Jenkins.

We look forward again to working with the Ways and Means Committee as we look at the issues of tough choices, deficit reduction, and yet equity in the budget process.

We welcome you, invite you to summarize your testimony, and submit your complete statement for the record.

STATEMENT OF HON. DAN ROSTENKOWSKI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS AND CHAIRMAN, COMMITTEE ON WAYS AND MEANS

Mr. ROSTENKOWSKI. Mr. Chairman, thank you very much for those kind words. I have had the pleasure, as you well know, of working with the three gentlemen that you've described, and I'm certainly pleased that not only are they interested in the budget and the presentation of guidelines, but they also serve very well on the Ways and Means Committee, and I'm sure, in their own inimitable way, they protect the prerogatives of that committee as well.

Mr. Chairman, I'm pleased to appear here today, and I would like very much to have unanimous consent to introduce into the record my entire statement; however, I would like to summarize it.

The CHAIRMAN. Without objection.

Mr. ROSTENKOWSKI. Mr. Chairman, we are all aware of the recent Congressional Budget Office estimates showing a substantially lower deficit over the next few years than previous projections. These new estimates must not deter us from making every effort to achieve the deficit targets enacted in Gramm-Rudman.

As you develop the fiscal year 1987 budget resolution, I urge you to use realistic economic assumptions. I also strongly recommend that you use the Gramm-Rudman baseline, which requires real savings and avoids the inflated estimates of last year.

In my opinion, the President's budget is unrealistic in terms of the reduction in domestic spending and the increase in defense spending it assumes. Given the large reductions in domestic programs enacted in recent years, I do not think it is politically feasible or appropriate to make the large additional cuts contained in the President's budget.

With regard to the President's position on defense spending and taxes, I think he is going to have to make a choice. He is going to have to choose between a budget with a large increase in defense spending, coupled with the tax increase to pay for it, or a budget

without a tax increase and a substantially smaller amount for defense.

Let me emphasize, Mr. Chairman, it is imperative that the President support any tax increase that is included in the 1987 budget.

I find it distressing to begin working on next year's budget when we have yet to finish our work on last year's. We must pass last year's reconciliation bill. As in the past, the Committee on Ways and Means will make every effort to comply with the congressional budget directives.

Following the pattern of recent years, the President's budget proposes large reductions in programs within our jurisdiction, including $6 billion for fiscal year 1987 and some $27 billion over 3 years.

A large portion of these cuts occur in the Medicare Program. As we consider the President's new Medicare proposals, we must keep in mind that every year since 1981, we have enacted major changes in this program. The changes enacted to date have reduced Medicare outlays by $45 billion over the period of 1984 to 1988.

In their budget, the administration proposes a large increase in part B Medicare premiums, as well as other proposals that will significantly increase out-of-pocket costs for beneficiaries.

It is simply not reasonable to expect providers and beneficiaries to absorb the level of reductions proposed by the administration in the Medicare Program.

Many of the other programs within the jurisdiction of the committee, including AFDC and SSI, were exempted in Gramm-Rudman and should also be exempted in your budget deliberations. AFDC has been reduced by 12 percent since 1981. As a result, fewer and fewer families with children are escaping poverty. Thus I would urge this committee to avoid further reduction in AFDC, SSI, and related programs.

The Committee on Ways and Means takes note of the fact that the President's budget for fiscal year 1987 contains numerous receipt proposals which increase revenues by $6.3 billion during 1987. It appears from the information available that some $3 billion of receipts may not be within the legislative jurisdiction of the Committee on Ways and Means. I point this out so that any revenue increase directives included in the budget resolution will be properly allocated to the appropriate committees.

We are all aware that the President has been very adamant in his public statements that deficit reduction be achieved through spending cuts alone. His position is that tax increases have been removed from the table.

I find this position to be regrettable, and I believe that it contributes to a feeling in Congress and the general public that the President's budget is not credible or realistic.

In expressing, Mr. Chairman, support for the consideration of revenue increases in developing out 1987 budget, I want to emphasize that such increases must not be considered as an exclusive remedy, but rather as a potentially important component of our deficit reduction effort. It is essential that we enact a responsible deficit reduction package this year. This means the President and the Congress must approach this critical and difficult task with flexibility and cooperation.

I am convinced that the public is much more concerned about the ability of Congress and the President to reach a decision on a deficit reduction bill than they are about the specific defense, domestic, and tax components of the bill.

The Committee on Ways and Means is prepared to work with you, Mr. Chairman, in the development of a fiscal year 1987 budget that will demonstrate to our constituents that we are serious about deficit reduction and that we have not lost our capacity to make the difficult decisions that are required.

Thank you, Mr. Chairman. That concludes my testimony.

[The prepared statement Mr. Rostenkowski follows:]

PREPARED STATEMENT OF HON. DAN ROSTENKOWSKI

Mr. Chairman and members of the Budget Committee, I am pleased to appear here today to comment on the administration's fiscal year 1987 budget. I will begin my remarks with some general observations about how the House might respond to the President's budget in fulfilling its responsibility to develop a fiscal year 1987 congressional budget. I will then focus on the impact of the President's budget on the jurisdiction of the Committee on Ways and Means and how the committee might respond.

We are all aware of the recent Congressional Budget Office estimates showing a substantially lower deficit over the next few years than previous projections. We are also aware that some of the assumptions used in this rather optimistic estimate are subject to debate and modification. These new estimates must not deter us from making every effort to achieve the deficit targets enacted in Gramm-Rudman. As you develop the fiscal 1987 budget resolution, I urge you to use realistic economic assumptions: assumptions that will not come back to haunt us in September. I also strongly recommend that you use the Gramm-Rudman baseline, which requires "real" savings and avoids the inflated estimates of last year.

Whatever the estimated difference between projected deficit for 1987 and the Gramm-Rudman target, whether it be $30, $40, $50 billion or more, there are basically three ways to meet the required deficit level: Reductions in domestic spending, reductions in defense spending, and increases in tax revenues. In my opinion, the President's budget is unrealistic in terms of the reduction in domestic spending and the increase in defense spending it assumes. Given the large reductions in domestic programs enacted in recent years, I do not think it is politically feasible or appropriate to make the large additional cuts contained in the President's budget, with regard to the President's positions on defense spending and taxes, I think he is going to have to make a choice. He is going to have to choose between a budget with a large increase in defense spending coupled with a tax increase to pay for it; or, a budget without a tax increase and a substantially smaller amount for defense. He cannot have it both ways: He cannot have a large increase in defense *and* no tax increase. Let me emphasize, it is imperative that the President support any tax increase that is included in the 1987 budget.

I find it distressing to begin working on next year's budget when we have yet to finish our work on last year's. We must pass last year's reconciliation bill. The pending conference agreement contains $20 billion in deficit reductions over the 3 year period, $7 billion of which will help us reach next year's $144 billion Gramm-Rudman target. We must resist any temptation to postpone these savings. Approximately $6 billion of the 3-year savings are because of increased tax revenues, including $4.2 billion from the extension of the 8 cent increase in the cigarette tax. As a part of the reconciliation bill, these revenues will result in real deficit reductions. If reconciliation does not pass, these revenues are likely to be used in other bills to offset the costs of revenue losers or outlay increases.

As in the past, the Committee on Ways and Means will make every effort to comply with congressional budget directives. Following the pattern of recent years, the President's budget proposes large reductions in programs within our jurisdiction, including $6 billion for fiscal year 1987 and some $27 billion over 3 years.

A large portion of these cuts occur in the Medicare Program. We possibly can accept something less than a full marketbasket increase in the prospective payment system for hospitals. For the most part, however, the additional Medicare savings called for by the President beyond those contained in last year's reconciliation bill are neither appropriate or feasible.

As we consider the President's new Medicare proposals, we must keep in mind that every year since 1981 we have enacted major changes in this program. Changes enacted to date have reduced Medicare outlays by $45 billion over the period 1984 to 1988. This reduction is due to numerous policy changes that have cut payments to providers and increased out-of-pocket costs to Medicare beneficiaries. These changes include major innovations like the prospective payment system for hospitals, enacted in 1983, that completely altered payment procedures that had been in effect for decades.

In their budget, the administration proposes a large increase in part B Medicare premiums as well as other proposals that will significantly increase out-of-pocket cost for beneficiaries. Furthermore, it proposes to institute by regulation a new reimbursement system for hospital capital and to reduce physician reimbursement for certain procedures. It simply is not reasonable to expect providers or beneficiaries to absorb the level of reductions proposed by the administration in the Medicare Program. Also, we must consider these proposed changes in light of the current disruption and problems in the Medicare Program caused by the many policy changes and budget cuts that have been implemented in the past several years.

Many of the other programs within the jurisdiction of the committee, including AFDC and SSI, were exempted in Gramm-Rudman and should also be exempted in your budget deliberations. AFDC has been reduced by 12 percent since 1981. In addition, States have reduced the purchasing power of AFDC benefits by some 35 percent since 1970. As a result of those changes, fewer and fewer families with children are escaping poverty and, indeed, since 1981 we have made it much more difficult for them to escape poverty. The statistics are quite clear on this point. Thus, I would urge this committee to avoid further reduction in the AFDC, SSI and related programs

The Congressional Budget Office estimates fiscal year 1987 revenues at $844 billion. Last year, the House passed H.R. 3838, the Tax Reform Act of 1985. I expect the House and Senate to pass a conference report on tax reform sometime later this year. One principle that has been present throughout the tax reform debate, and which will be maintained, is that the final tax reform legislation will be revenue neutral as compared to current law.

The Committee on Ways and Means takes note of the fact that the President's budget for fiscal 1987 contains numerous receipt proposals which increase revenues by $6.3 billion during 1987. It appears from the information available that some $3.0 billion of these receipts may not be within the legislative jurisdiction of the Committee on Ways and Means. The proposals which appear to be outside the committee's jurisdiction include civil service retirement contributions, petroleum overcharge restitution funds, certain user fees, and other miscellaneous proposals. I point this out so that any revenue increase directives included in the budget resolution will be properly allocated to the appropriate committees.

With respect to the administration's proposals for an IRS cost of collection charge, it should be pointed out that this concept has already been approved and incorporated in the tax reform bill. Therefore, the three-year savings of approximately $1.1 billion should not be double counted.

On a related matter, I urge your committee to reject the administration's proposal to impose users' fees on virtually all customs' transactions. Although this proposal is appealing on its face because it would result in additional receipts of over $500 million per year, the proposal is extremely controversial and has a number of problems associated with it. During our consideration of this proposal last session, the House Committee on Ways and Means and Senate Committee on Finance opted for a more modest users' fee proposal which is in last year's reconciliation bill. This provision assesses fees only on arriving passengers and conveyances, but not on merchandise, and raises annual revenues of about $200 million per year. Although this, too, was controversial, it avoided many of the problems inherent in the administration's more comprehensive proposal. We would, therefore, urge you either to drop the customs' user fee concept entirely or at the very least adopt the more modest approach endorsed by this committee last year.

We are all aware that the President has been very adamant in his public statements that deficit reduction be achieved through spending cuts alone. His position is that tax increases have been removed from the table. I find this position to be regrettable and believe that it contributes to a feeling in Congress and the general public that the President's budget is not credible or realistic. To begin developing a budget that aims at substantial deficit reduction by rejecting at the outset the possibility of tax increases is to ignore an important tool available to the President and Congress.

In expressing support for the consideration of revenue increases in developing our 1987 budget, I want to emphasize that such increases must not be considered as an exclusive remedy, but rather as a potentially important component of our deficit reduction effort. Let me also emphasize that I feel the President's support for such a revenue increase is a political imperative.

With the President providing leadership on balanced deficit reduction packages in 1982 and 1984, the Congress responded in an expeditious and bipartisan fashion. Significant deficit reductions, both of which included revenue increases, were achieved in both years and without any negative effect on the economy's expansion or growth. Both bills brought a measure of confidence to the general public and financial markets.

It is essential that we enact a responsible deficit reduction package this year. This means the President and Congress must approach this critical and difficult task with flexibility and cooperation. I am convinced that the public is much more concerned about the ability of Congress and the President to reach a decision on a deficit reduction bill than they are about the specific defense, domestic and tax components of the bill.

The Committee on Ways and Means is prepared to work with you in the development of a fiscal year 1987 budget that will demonstrate to our constituents that we are serious about deficit reduction and that we have not lost our capacity to make the difficult decisions this requires.

The CHAIRMAN. Thank you very much, Chairman Rostenkowski.

I agree totally with you on your statement on page 3 with regard to reconciliation. I know that you and your committee have been working very, very hard, made several offers to the Senate with regard to resolving difficulties, and have not had any response whatsoever. I just think it's very tragic that the Senate has not been able to respond to the offers that have been made, that somehow we do solve the problem of reconciliation, so that we can achieve those savings.

Mr. ROSTENKOWSKI. Well, Mr. Chairman, hope springs eternal, and we're still trying to negotiate a fair remedy.

The CHAIRMAN. Well, I wish you well in that endeavor, and you have the support of the Budget Committee in pushing that forward in trying to come to an equitable decision.

Let me ask one question, Chairman Rostenkowski. You mentioned on page 7 the revenue increases of $6.3 billion in 1987 in the President's budget. As you know, he calls those revenue enhancers. But some of us think that a rose is a rose and that these are taxes in disguise under the name of "revenue enhancers." How do you feel about that description?

Mr. ROSTENKOWSKI. Well, any increase, Mr. Chairman, as you well know, regardless of whether you call them revenue enhancement programs or whether you increase premiums, one has to view those things as increases that the public pays. I find it very difficult for me to accept some of the recommendations and suggestions by the administration.

I have, for a long period of time, been one that felt that increases in revenues are necessary, if we're going to be serious about what we can do with respect to the deficit, and I am disappointed and somewhat frustrated that this administration refuses to view what I think the American public is willing to accept.

I'm not pleased, and I say this somewhat admonishing my own colleagues—I don't think the American people are happy with the alphabet, DOA, dead on arrival. I don't think the American people are happy with VOA, the President saying that any changes will

be vetoed on arrival. I think the American people want accomplishment; they want progress.

I found out that in just a close association I had for a period of 20 minutes on television when I suggested to the American people that if the President is right, we'll support him. And if he's wrong, where we think he's wrong, we'll try to correct it, and I hope that he doesn't become adamant about where we think he's wrong, but that he sits and reasons with us.

That is a problem that we face here in Washington. But I do not think that it is necessarily confined to Washington. I think people generally are becoming very disappointed in their Government and the adversary relationship that constantly exists in our negotiations.

And so for what its worth, Mr. Chairman, I think that we are going to have to bite the bullet and I really think that the American people are willing to accept some discipline. But I think it has got to be shared across the board in every area.

Mr. Jenkins, who serves on the Committee on Ways and Means, can—I am sure—attest to this. We have done, at your direction and the direction of chairmen before you, a tremendous amount of real difficult decisionmaking. But we have managed to, I hope, try to cut those programs or cut the waste with a scalpel, as opposed to the ax.

The CHAIRMAN. Well, certainly, I can attest to—since I have been the chairman—that this has been the case with the Ways and Means Committee. You have made significant changes and savings, and you have done it with a scalpel as opposed to a meat ax approach.

The gentleman from Georgia, Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman. I would like to express my appreciation to my chairman for his appearance.

I do have one question. The Budget Committee has been beginning to wrestle with this problem. As we look at the coming budget resolution, it appears that the administration thus far is saying to the Congress that revenues cannot be on the table.

I know that most of us agree that if we continue with the defense figures, as you indicated in your testimony, there is not much of a way to arrive at a resolution in the absence of revenues. From your testimony and from the testimony of other witnesses, it appears that the proposed budget cuts are just not there.

I think what the Budget Committee is beginning to wrestle with now is whether or not we go ahead and try to put together a resolution without any revenues, in view of the President's admonition and stern position, or whether we simply try to formulate a budget resolution, even if it includes revenues, in the absence of Presidential support.

Do you have any——

Mr. ROSTENKOWSKI. Well, Mr. Jenkins, you and I have discussed this in more private quarters. I have had glowing experience in the last 12 months. I know the power of the Presidency and I know that should the legislature, either the House or the Senate, organize an effort to increase taxes in order to balance the budget, that we give the President the opportunity to criticize.

I have only found that without the President's help it is quite difficult for us to be able to convince enough of our colleagues to support legislation.

These are qualities of leadership. And this is a President that, in my opinion—and I see no reason to doubt his charismatic abilities—if he wants to be a great President he has to bite the bullet and he has to suggest that revenues be included.

I think it would be a dramatic step, and it would be a step in the right direction. But how successful, Mr. Jenkins, it would be is doubtful.

Mr. JENKINS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Rostenkowski. We look forward to working with you and I, too, agree with your analysis although I am not a member of the Ways and Means Committee that has the jurisdiction. But I just know out there, on the floor, without a President's support and without a President holstering the .44 Magnum veto gun, it would be extremely difficult to do anything on the revenue side. My concern is I do not want to put together a budget that looks good on paper but cannot be implemented.

So I tend to agree with——

Mr. ROSTENKOWSKI. Mr. Chairman, if experience is any guide, there are very difficult, frustrating days when you are acting as chairman. Sometimes the handshake is weaker than it was the day before. But all I can do is suggest to you that with your strength and your ability and the cooperation of your committee, that you do what is right for the country. And we would like to see the President support it.

The CHAIRMAN. Thank you, Chairman Rostenkowski.

The committee will recess until 2 o'clock this afternoon, when we will have the Governors bipartisanly appear from the Governor's Conference of the United States.

AFTERNOON SESSION

Mr. SLATTERY [presiding]. The committee will come to order.

We have four distinguished Governors here today.

I want to welcome Governor Clinton from Arkansas, who is to be the chairman of the National Governor's Association; my Governor from Kansas, Gov. John Carlin, who served previously as the chairman of NGA, who is the lead Governor for budget issues for the NGA; and Governor Sununu from New Hampshire, who is also chairman of the Republican Governor's Association; and Governor Janklow from South Dakota, who is the expert on farm issues.

So, I welcome you to the committee today.

It is also my understanding that the Governors have had an opportunity, this weekend, to be briefed by members of the Cabinet and that yesterday they met with the President also.

As you know, the President's fiscal year 1987 budget dramatically reduces Federal assistance to State and local governments. The President's budget requests $89.1 billion in the budget authority for the total grant assistance to States and localities, which is a $27 billion decrease compared to the CBO fiscal year 1987 baseline. This is a 25-percent reduction in just 1 year.

The President's 1987 budget is a continuation of past policies. The 1987 budget assumes that Federal aid to States and localities will continue to decline from the 15.5 percent of total budget outlays it represented in 1980 to 10 percent in 1987 and 9.1 percent by 1991. By any measure, whether in terms of total budget outlays, or present or total GNP, or as a percentage of State and local receipts from their own sources, the President's proposals attempt to turn back the hands of time to funding levels last seen prior to the 1970's.

If you would allow me to quote from the joint statement issued by the National Governors Association and the National Conference of State Legislatures. "The net effect is that the Federal Government is transferring its fiscal distress to State and local governments."

Another quote I found interesting was "States are simply in no position to make up the huge cuts in domestic aid."

The National Governors Association's past budget policy statements have shared the same concerns regarding fairness, equity, and balance that the Congress has incorporated into the congressional budget resolution for fiscal year 1986.

The Governors of this Nation have been clear in their position that there must be a balance between defense and nondefense domestic spending reductions. We have shared our view that everything should be on the table for discussion, even the potential need for increases in Federal revenues as well as possible entitlement reforms and changes in our current Federal system.

At today's hearing we welcome the opportunity to discuss your current budget policy position. We would like to explore with you what an appropriate policy of Federal assistance to States and localities should be in a period requiring significant reductions in the Federal budget.

The committee needs to know your program priorities and what Federal and State responsibilities might be appropriate candidates for reductions. We are also concerned with the budgetary and economic conditions of the States—particularly in light of the current farm crisis—the impact of declining energy prices on many oil and gas States, and the serious dislocations caused by the overwhelming international trade deficit.

As the chief executives of the 50 States, you are the operators of the Federal assistance programs and are on the proverbial firing line.

We sincerely appreciate your appearance here today and we are most interested in any alternative suggestions you may offer in aiding this committee to produce a budget resolution with an appropriate set of program priorities that achieves substantial deficit reduction.

At this time, the Chair would recognize the gentlelady from Illinois, Mrs. Martin, for any opening statements she might have.

Mrs. MARTIN. Welcome gentlemen. We await your pleasure.

Mr. SLATTERY. Governor Carlin.

STATEMENT OF HON. JOHN CARLIN, GOVERNOR OF THE STATE OF KANSAS

Mr. CARLIN. We thank you for this opportunity. Next time we will not submit our full text far in advance because we have to assume the rest of the members are off studying our presentation. We will not make that mistake again.

I want to very quickly summarize, because you do have the full text and we are not going to bore you by reading it.

I will very quickly cover four areas, our general position on the budget, a little bit about our fiscal condition in the States for taking additional responsibility, a response to the President's budget, and a little bit on timing.

Our resolution on the budget, we have testified here before. You are very well acquainted and indicate that in your opening remarks. I would simply underline the point that the Governors feel that everything needs to be on the table. And only from that perspective can you really viably put together not only a sound budget but one that is politically viable as well.

And we include, as you indicate in your opening statement, Congressman, the issue of revenue.

I do want to clarify a little bit in regard to State fiscal condition, as it relates to your desire to shift responsibilities. We realize there are going to be cuts. We are ready to accept additional responsibility, but we do not want you to do that on the basis that somehow we have got a pot of gold out there just ready to invest in whatever you are backing away from.

That is not the case with the modest exception of maybe two or three, four or five States. Many States are in serious financial trouble. I am currently before the legislature with a general tax increase just to get by. There is no surplus for the bulk of us. And what little does exist is really tied to the fact that we balance our budgets. We have to have some money in the kitty to pay our bills and keep the cash-flow going to make that possible. So, keep that in mind.

We will accept our responsibilities, but you had better assume that whatever you send our way, we are going to have to raise taxes from your constituents as well, in order to pay for those programs.

As far as the President's budget, there is not any question. On the one hand, the good news, he reaches the targets we have suggested in terms of ultimately accomplishing the objective. We have serious disagreement, though, with the President in regards to how it is done. It would center around our policy of putting on the table. And then, with everything on the table, using some common sense and making sure that whatever sorting out is done in consistency with what is in the best national interest.

I use Medicaid as an example. We believe very strongly, in terms of income maintenance programs, that they must maintain strong support at the national level and would remind you in the context of looking at whatever proposal—yours or the President's—that that is a program where when you shift additional responsibility to the States, the States that have the largest burden are the States with the least capacity to respond to that need.

I hope that is a point that you can keep in mind as you proceed.

One last point and then I will let my colleagues, if they want to add, to do so and we will respond to your questions. We acknowledge, one way or another—whether it is through Gramm-Rudman or your inspiring leadership or whatever—that there is going to be a budget and the budget will include cuts, significant ones that will affect State and local government.

You can help considerably if you just remember the value of appropriate timing. To settle it in April or May, that is a big difference than September, October, or November. We are well into our fiscal years, as well as yours. We still do not have the final numbers, much less have any reading at all on the following fiscal year.

There are legislatures that are out of session, soon to be out, or not even in this particular year. So, the earlier you make decisions, the more transition time you build in, the better we are able to receive additional responsibility and accept it and handle it in somewhat of an efficient, effective way.

We do not raise that on behalf of us, as administrators. We raise it on behalf of those people who are affected by programs out there who literally, in the transition, can be cut off and suffer great difficulty if we are a little careless in how we pass the ball from the Federal to the State and local level.

With that, I would yield to any of my colleagues for comment or your questions.

[Testimony resumes on p. 706.]

[The prepared statement of Mr. Carlin follows:]

Prepared Statement of Gov. John Carlin

Mr. Chairman, it is a pleasure for me to be here as you continue your review of the federal budget for fiscal 1987. In my statement this afternoon, I would like to address four issues which I believe are important in your budget deliberations:

- The Governors' position on the federal budget,
- the current fiscal condition of the states,
- the potential impact of the President's budget on state governments, and
- the importance of early congressional action on the budget.

Federal Budget Position

From an economic and federal budget perspective, recent news has been encouraging. First, current policy projections for both OMB and CBO reflect a major shift in the long-run deficit path from increasing to decreasing as a share of the GNP. Due to the redefinition of the national defense and non-defense discretionary spending baselines, coupled with the out-year impacts of the 1986 Gramm-Rudman-Hollings sequester, CBO now sees the deficit coming down from $181 billion in 1987 to $104 billion in 1991. Second, the recent drop in oil prices and the decline in the value of the dollar should both contribute to a continuing expansion which could reduce the near-term deficit even further.

There are, however, also signs of problems. If the value of the dollar continues to fall, its impact on the price of imports could increase the risk of renewed inflation. Perhaps even more risky is that a continued decline may result in foreigners decreasing their holding of dollars -- other things being equal, this could increase interest rates, stall the economy, and substantially increase the federal deficit.

Although the outlook is somewhat brighter in the short run, the massive deficit continues to cause major problems in the agriculture as well as other

industries ranging from micro-electronics to automobiles -- those which need to compete in the international economy. Furthermore, additional declines in the value of the dollar could cause the optimism to fade quickly if foreigners begin to lose faith in the dollar. For these reasons, it is critical that major deficit reductions remain the number one priority for the Congress. The time is now, while the economy is continuing to expand -- once growth stalls, it will not be a politically viable option.

These economic concerns have led the nation's Governors to adopt a comprehensive bipartisan position on the federal budget for the last three years. The current NGA position, which was just adopted at our winter meeting last February, calls on the Congress to enact a freeze on federal spending that shares the burden among national defense and domestic spending and that does not burden already hard-pressed, lower income Americans. Specifically, the policy calls for freezing the 1987 appropriation at the 1986 level for non-defense discretionary spending. National defense appropriations in 1987 should be limited to the 1986 level plus inflation. The growth in other entitlement and mandatory spending programs would also be restrained. Part of this restraint would be caused by a one-year freeze of all cost-of-living adjustments, including Social Security. Furthermore, the NGA policy urges the Congress to review the Medicare, federal pensions, farm, and Social Security programs to determine what reforms can be enacted in these non-means-tested entitlements. The reforms would be designed to increase the long-term controllability of the federal budget while continuing to protect low-income beneficiaries. Selected means-tested entitlements* are assumed to receive

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* AFDC, Food Stamps, Title XX, Medicaid, SSI, child nutrition, and child welfare services

full funding in the NGA position. We believe that these programs have already contributed their share of budget reductions. After the budget freeze and reforms have been enacted, it may be necessary to increase revenues to reduce the deficit to the NGA goal of 1 percent of GNP by 1990.

Our policy urges that the combination of the budget freezes and program reforms adopted by Congress be consistent with the long-run goal of attaining a balanced federal budget. To this end, we have recommended the adoption of procedural changes at the federal level: a constitutional amendment requiring a balanced federal budget and providing the President with line-item veto authority. We recognize that the federal budget differs in some respects from state fiscal responsibilities, but we have observed that these procedures impose a useful discipline at the state level which may be helpful to federal policymakers.

Our intent in developing our budget policy is not to be critical, but to say we are willing to assist by both accepting a freeze on many state programs and by helping to build a national consensus to enact a major deficit reduction plan this year while the economy continues strong. The window of opportunity for deficit reduction may close in the near future if the economy begins to slow.

State Fiscal Condition

As partners with both federal and local governments in the delivery of services to our citizens, the Governors wish to assist in deficit reduction. However, we are opposed to large shifts in current federal responsibilities to state government based on the misconception that states have fiscal surpluses.

Clearly, the current fiscal condition of the states does not provide a bright picture. Peliminary results from a National Governors' Association/ National Association of State Budget Officers' fiscal survey of the states

show that the most important recent development appears to be the rapidly deterioriating fiscal condition of many southern, mid-western, and western states.

Already, 16 states have been forced to cut their current year's budget to avert impending deficits, mostly in special sessions. And the states of Arkansas, Idaho, and Mississippi have had to cut their FY86 budgets twice.

The two most distressed regions of the country are the mid-west and west. Farm-belt states -- especially Iowa, Nebraska, and Kansas -- are in poor fiscal shape as a direct result of a deteriorating farm economy.

The fortunes of farm-belt states cannot be separated from the financial condition of its farmers. Iowa and Nebraska have cut fiscal 1986 budgets and Nebraska raised taxes in a special session last November. Both Kansas and Nebraska Governors are proposing fiscal 1987 budgets that are smaller than the fiscal 1986 budget.

Minnesota and Wisconsin also have large farm sectors in their economies and both have had to cut back sharply on current biennial expenditures. Both states are also projecting significantly lower economic growth for the remainder of the biennium.

The most dramatic change in fiscal fortunes is that of the energy-based states in the west and southwest. Western state economies had not been performing well over the past two years, but now with recent changes in oil prices, many western states may be dealing with a regional recession. From December to February, the price of crude oil dropped dramatically from $25 per barrel to $15, forcing states that heavily depend on oil revenues to markedly alter revenue and budget projections for the remainder of this fiscal year and the upcoming year. For example, in January, Texas was projecting the price of oil in fiscal 1987 to be selling for $24.50 per barrel. In February, the state comptroller revised the estimate to $15 per barrel. This change in

revenue estimates translates into a $1.3 billion biennial revenue loss, forcing the state to slash appropriations 13 percent for the remainder of the biennium. For every dollar per barrel the price of oil declines, Texas state government loses $70 million in direct revenue. It also means that the state loses 250,000 jobs.

In Oklahoma, revised estimates mean state spending in fiscal 1987 will be an unprecedented 18 percent less than in the current year. Large layoffs of the state workforce will result, and many planned expenditures are being postponed indefinitely.

Also important, but often ignored, is the loss of state tax revenue that is indirectly collected from the oil industry as a result of reduced general economic activity. For example, Texas estimates that it loses $30 million in sales taxes for every $1 drop in oil prices, while Louisiana estimates the loss to be $17 million attributed to loss of sales and income tax collections.

Some southern states are also experiencing fiscal difficulties. For example, North Carolina recently enacted a state personnel hiring freeze, South Carolina cut the fiscal 1986 budget by 2 percent, and Florida may increase taxes a small amount this year. States experiencing greater fiscal stress include Mississippi and West Virginia, which are proposing substantially smaller budgets next year than current levels. West Virginia still has the highest unemployment rate in the country.

The good fiscal news is that many northeastern states are experiencing strong economic growth and only Vermont has had to cut its current year's budget. No states in this region are projecting deficits and a few of these states even may offer some tax relief this year.

Just recently, the Governors have submitted their recommended fiscal 1987 budget to the legislature. According to preliminary survey estimates, budget growth will be below 5 percent and the ending balances will be about $3

billion -- less than 2 percent of expenditures. States are proceeding on a cautionary course, but the number of unpredictable factors are disturbing. Surely you can understand the difficulties of budgeting when faced with a possible economic downturn, and unknown action that may be taken by Congress to reduce intergovernmental aid.

The Impact of the President's 1987 Budget on State Governments

I commend the administration for submitting a budget which meets the deficit targets of Gramm-Rudman-Hollings and is also in line with our own policy for deficit reduction. Regarding the allocation of cuts, however, the President requests substantially larger cuts in the non-defense discretionary portion and far less in the national defense and middle-income entitlement programs than the Governors' policy proposes. Furthermore, we would have to take great exception to the proposed cut in Medicaid and other safety net programs.

Overall, we do not believe that the President's budget shares the burden equally across defense and non-defense spending. With respect to national defense, spending will have increased 105 percent between 1981 and 1989. It appears that some slowing of this rate of increase is appropriate to maintain the cost-effectiveness in weapons systems and other procurement. Non-defense discretionary spending has already been reduced 25 percent in real terms over the last five years, and the President is proposing huge cuts again in this area. Given that this is the investment portion of the budget (education, job training, infrastructure, research and development), we do not believe additional reductions are wise.

To make all the budget cuts in the non-defense discretionary portion of the budget merely puts off the real problem another year. All the projected

growth in the budget this year, as well as that projected for the future, is in national defense and middle-income entitlements. These are the components which must be restrained and must share in the burden.

Attached is a list of major reductions in grants-in-aid programs proposed in the President's fiscal 1987 budget. As you can see, the cumulative amount over five years is over $111 billion. We all know that many of these programs are essential but if federal participation ends, the programs and services will be directly affected. States do not have the resources to replace lost funds, especially for the majority of local programs that are being proposed for termination. The House Budget Committee has always recognized a national purpose for many of these programs. The Governors will support you, especially in protecting the safety net programs as you have done in the past, and were able to have exempted in the new Gramm-Rudman-Hollings law.

Federal responsibility for Medicaid and other basic means-tested programs is essential because individuals with the greatest needs tend to be concentrated in states least able to meet these needs. It is instructive to review the circumstances of states disproportionately affected by the administration's Medicaid proposal. Idaho is a state where a number of basic industries such as agriculture, timber and hard-rock mining are severely weakened at the present time. In this fiscal year alone, the Governor of Idaho has already had to cut the state budget twice because of state revenue declines. We estimate that the proposed cap would reduce federal Medicaid funds to Idaho by about 16 percent in fiscal 1987, and in turn require Idaho to increase state funding by an estimated 36 percent just to maintain the current Medicaid program. The most recent available federal estimates indicate that Idaho's Medicaid program covered only 18 percent of poor state residents in 1982. Nationally, the proportion of poor persons eligible for

Medicaid has declined to less than half. This is both because the poor population has grown, and because states have been fiscally unable to adjust Medicaid eligibility standards to keep pace with inflation.

The proposed Medicaid cap would mean that Mississippi, the state with the highest percentage of poor persons and the highest infant mortality rate, would have to increase state outlays in 1987 by 28 percent just to maintain its current Medicaid coverage if the Medicaid cap is adopted. The state of Utah, which has already adopted budget cuts and will have to adopt further cuts due to its sluggish economy, would have to increase state Medicaid service outlays by an estimated 49 percent just to maintain its current law program. South Carolina, the state with the nation's second highest infant mortality rate and third lowest per capita income, would have to increase state FY 1987 outlays by over 50 percent according to its current law program estimates. Last year, South Carolina raised its Medicaid and AFDC eligibility threshold for mothers and children as a critical component of the Governor's initiative to reduce the state's infant mortality rate. A federal Medicaid cap would essentially preclude states that now cover very small and declining proportions of their poor populations from such improvements. States are not in an economic position to offset major federal Medicaid cuts. It seems clear that such cuts would result in further cuts in basic health care services for our most vulnerable citizens. The NGA position is that the federal government should assume more not less of the Medicaid program as other programs are reduced or terminated.

At a time when much of the informal private sector subsidy for the care of the poor is disappearing, it would be inexcusable for the federal government to curtail its responsibility for the Medicaid program. The entitlement nature of this program must be maintained.

The Governors already have a tremendous incentive to contain Medicaid outlays. States share in any increases in Medicaid costs, which represent the largest state-administered program cost in state budgets. In their cost containment efforts, the states are aggressively using the increased Medicaid policy latitude the Governors asked for and received from the Congress in 1981. However, it must be noted that Medicaid provider payment rates are already substantially below Medicare rates, and Medicaid funding often is targeted towards financially stressed providers who serve large numbers of the medically indigent. In instances where a Medicaid payment rate freeze reduction is appropriate, many states would need additional federal statutory authority to adopt cuts similar to those proposed for the federal Medicare program. It should also be noted that despite the freeze in physician payment rates, Medicare outlays to physicians continue to increase at double-digit rates because of the design of Medicare payment policies. NGA supports reforms in Medicare physician payment systems to improve cost accountability and reduce incentives for more services in more expensive settings, and we will continue to work with the Congress to reduce unnecessary Medicaid costs. However, we will strongly resist cutbacks in basic federal programs for the poor.

The Importance of Early Congressional Action

The Gramm-Rudman-Hollings 1986 reductions will have an impact on states, particularly in light of the current fiscal condition outlined above, coupled with the fact that there was no early notification, and states are currently halfway through the fiscal year. These last-minute changes create uncertainty and inefficiency in planning, budgeting, and spending at the state level.

Such uncertainty could even be much more disruptive next fiscal year and, thus, I urge you to reach an early agreement with the Senate and the administration on a deficit reduction bill -- hopefully, by April 15th.

The potential uncertainties regarding this year's budget decision appear much greater this year. First, there are major questions regarding the constitutionality of the automatic enforcement mechanism of the Gramm-Rudman-Hollings deficit reduction legislation and how the Congress and the President will proceed if it is declared unconstitutional. Second, there may be competition for possible revenue increases -- that is, do they go for deficit reduction or to offset other revenue losses as part of a revenue-neutral tax reform plan. Finally, the recent $46 billion CBO downward re-estimate of the 1987 current policy deficit projection, coupled with uncertainties over the economy, indicates the uncertainties in estimating the magnitude of the reduction required to meet the $144 billion target in Gramm-Rudman-Hollings.

All of these issues point toward the critical importance of making early budget decisions. For us not to know the funding levels for state and local aid until September and then have it change substantially due to an automatic sequester is unfair to the citizens of the states which we both represent.

Mr. Chairman, I would be happy to answer any questions.

Table

Major Reductions in Grant-In-Aid Programs
Outlays in Millions of Dollars

PROGRAM	FY 1987	FY 1987-91
Medicaid	$2,392	$26,272
Revenue Sharing	4,433	22,165
Housing Programs	1,945	12,706
Federal Aid Highways (Trust Fund)	485	7,616
Mass Transit	47	5,913
EPA Construction Grants	65	5,181
Child Nutrition	506	3,418
Community Development Grants	20	2,236
Vocational and Adult Ed.	151	1,957
CSA Block Grant	306	1,900
Training and Employment Services	157	1,587
Airport Grants	30	1,513
Health Resources and Services	305	1,436
AFDC	237	1,165
Work Incentives	183	1,101
Energy Conservation	122	1,099
Forest Service Receipts	215	996
Urban Development Action Grants	61	993
Impact Aid	106	880
Low Income Home Energy Assistance	9	857
Compensatory Education	0	674
Watershed and Flood Prevention	36	649
EDA Programs	47	632
All Other	1,648	8,287
Total Grant Reductions	13,506	111,233

STATEMENT OF HON. JOHN H. SUNUNU, GOVERNOR OF THE STATE OF NEW HAMPSHIRE

Mr. SUNUNU. Thank you very much.

I would like to support wholeheartedly, on behalf of the Republican Governors, the message given by Governor Carlin. I want to emphasize that the approach taken by NGA over the past few years has really received strong, strong bipartisan support.

If I could, I would like to summarize what I think are four important points that the bipartisan message is, to ask Congress to please do something about the deficit and do it quickly. I think that is the fundamental message and to suggest that any concerns that we might have raised are an excuse for doing less than should be done, I think is to undervalue what we think have been merely constructive suggestions as to moving some of the numbers around.

No. 2, we really do believe that everything should be on the table and, in some sense, Congress has done itself and the Nation a disservice by allowing some of the constituency groups to convince that you ought not to consider certain areas. In doing that, I think you have yielded too quickly, too easily, and made an unfair imposition and burden on what remains.

No. 3, we, as States, ask you as you go through the budget, where you do make cuts, to address the reality of the needs of the States in terms of flexibility so that we may implement best and most effectively and most efficiently the programs that we have to deal with. Remove some of the constraints and some of the limitations on us doing things in a way that understands and addresses the difference between New Hampshire and New York, between Iowa and California, between warm States and cold States, urban States and rural States.

And finally, and it is somewhat of a repetition, but to emphasize the fact that we hope that nothing we have indicated to you in terms of the preferences that the Governors have is misconstrued as a message or an excuse for not accomplishing what has to be done.

I really do believe that every Governor in the country, although they might express some displeasure at particular pieces of a program, would essentially say that whatever you do—as long as it is a constructive, positive response by men and women who have been entitled and empowered by their voters to make responsible decisions—if you act in a responsible way, we can deal with it constructively and effectively at the State level.

STATEMENT OF HON. WILLIAM J. JANKLOW, GOVERNOR OF THE STATE OF SOUTH DAKOTA

Mr. JANKLOW. Mr. Chairman, I would like to join in what my brothers John Carlin and also John Sununu have had to say with respect to the issues concerning the budget and the awesome responsibility that you folks face.

If I could make an emphasis from just a slightly different area. One of the unusual problems that we have to face, recognizing that something has to be done about this national deficit and the underlying debt that it builds upon, is the understanding that your fiscal year starts October 1. Ours starts July 1.

To delay your decisionmaking process, as to what you are going to do in fiscal year 1987 until we are into our next fiscal year will bring an unmitigated disaster, compounded on top of a catastrophe, onto the States. Twenty-five percent of our fiscal year will be gone. Operating under the existing budgets and the existing operations of the Federal/State partnership and the State obligations at the time that the new round is supposed to go into effect.

And to delay it until the end, which is the customary approach that historically that has been followed by the Congress, would just be a burden or a meal beyond which we could not stomach on the State level, with respect to our various constituencies.

The uncertainty that we have under Gramm-Rudman, where we get a new computer printout almost by the hour as to what its impact is, what does it mean as people continue to examine it and look through it really will be a very, very significant problem for all of us on the State level including—more important than our governments—our constituencies.

Second of all, I would like to reiterate and emphasize what it is that Senator Carlin—excuse me, Governor Carlin and Governor Sununu have said. And that is nothing should be untouchable in a democracy with respect to how the Government spends its money. Absolutely nothing. You have to recognize, and I think we all do, that in terms of establishing priorities some things come ahead of something else. And we do not all agree on what is No. 1, what is No. 2, and what is last.

But the fact of the matter is, to arbitrarily declare in advance that certain things are untouchable sets up a class system in advance that cannot be gotten around without causing problems on all the various sides.

I think it has to be fair whatever it is. No one is going to argue with the fact that straightening out this country's economic ill health shouldn't be fair. Two, it has to be uniform in terms of its application throughout the various States and the regions of the country. Three, every single thing that we have in this Nation, every program that Government sponsors, funds, or suggests, ought to be on the table in terms of what is considered, and they all ought to have hearings in terms of how the matter is approached.

I would support that the weakest national defense, one of the weakest links we could have in our national defense, would be an economic rot out there in certain areas of this land, whether it be in the textile communities, agriculture, in the smokestack communities, whether it be in the Sun Belt, the high-technology areas, it doesn't make any difference. An economic rot is something like a cancer that can grow and spread and cause awesome problems, specifically with respect to agriculture.

We in agriculture feel somewhat chagrined about the legislative action that has heretofore been taken by the Congress, not because we don't expect our fair share of cuts, because we do. We are about 2 percent of the national budget and we are in line for somewhere between 10 to 12 percent of the budget cuts under Gramm-Rudman.

If we very briefly look at the types of problems that the farm community finds itself in today or I should say agricultural America, there are really four areas that have primarily all been caused

by the National Government. One, no State has ever put an embargo on sales to foreign countries and disrupted the normal trading process that takes place throughout the world. When you recognize that an embargo is something that not only destroys your credibility as a supplier but at the same time it forces others to seek alternative means for their purchases which they may not want to back up on, you can understand how that has a compounded effect.

Two, interest rates. There is no one that I think would argue that any action of the States causes an increase in interest rates. The fact is I think most economists and people of economic thought or I should say most people looking at the economic facts, would agree that these interest rates are being driven by the incredible deficits and growing Federal debt that this Nation has had specifically over the last decade.

Three, the exchange rate on the dollar. There is nothing that any State or local government in America does to tamper with, deal with, or strengthen the dollar's activity with respect to its exchange rates. Just because they have dropped somewhat significantly over the last several months does not portend that we are going to be able to recapture the markets or make up for what we have lost during the period of time that we had those inordinately high rates, which by the way, we still have with respect to certain sectors.

Four, the whole area of protectionism which obviously goes beyond the scope of this committee, but deals with the area of the ability to play on a level plain surface throughout the world.

All four of these factors are things that we have to look to the National Government to deal with, because it is their unique responsibility to take care of this Nation in that regard.

Finally, I would like to suggest that in the area of budget cuts, I think some people overlook the fact of the tremendous number of cuts or dollar amounts of cuts that the States have taken with respect to what generally is perceived to be aid to the States. For example, when I was sworn in as Governor the first time in 1979, we had State revenue sharing of a very substantial sum of money. Two years later, that State revenue sharing went away. Those programs that had been put in place obviously were in the State's base, they had to be picked up and absorbed by the States.

I would dare say it was without a great deal of complaint that the State absorbed those kinds of cuts under the guise and the argument that we had to do something about these horrendous deficits that this country was running. Revenue sharing was eliminated and the size of the deficits went up, not down.

Second, with respect to various programs that the States deal with, we think it is incredible the types of regulatory rules and regulations that we have to comply with. I am going to cite a couple of examples.

For example, the community service block grant, which is an outgrowth of the old war on poverty. It is the old attempt to try and find unique solutions in the various areas of the country, each area, Harlem on one hand, rural Florida on another, western South Dakota on another, and California. Each area dealing uniquely with its own unique way of dealing with the problems of poverty.

Since I was sworn in in 1979, our State has received a 67-percent budget cut, or I should say appropriation cut, with respect to those community service block grants. Yet all the rules and regulations that were in place are still in place today; that is, Federal legislation that mandates the 90 percent of the community action agencies that were in existence at the time the block grant law was passed, must continue to be funded by the States with respect to the 67-percent less money that we get in the Block Grant Program.

The community development block grant [CDBG] in my State we received 18 percent less money today than we did at the time I was sworn in in 1979.

Alcohol, drug, mental health block grant; I think this is one of the most unique. For example, we received 16 percent less money today than we did in 1979. However, Federal law mandates that we must spend 35 percent of that budget for alcohol and alcohol abuse; 35 percent of it for drug abuse; 20 percent for prevention and early detection, and 10 percent for administration. Additionally, 5 percent of the entire grant, and by the way, the first numbers I gave you total 100, additionally 5 percent of the entire grant must be used for women's services under alcohol and drugs, which is 18 percent of all the alcohol and drug expenditures.

That is what is required by Federal law. There is no way that we can continue to administer under those kinds of constraints and circumstances.

For example, in my State, prevention and early detention may be a lot more important to address and deal with than in some other area of the country that has to deal with the type of programming where they already have a problem that they are trying to treat.

Social services block grant, which is the big social services grant to all the States, we received 20 percent less money. Maternal child health, 13 percent less money.

The point I am trying to make is this has been done to all the States without any objection and without any complaint, under the guise of trying to deal with these budgetary constraints that we find ourselves having to address in this country.

To sum it up, what I would like to say is this; you will find a true partner on a bipartisan basis, with the Democrat and Republican Governors of this country and frankly most of the political subdivisions of this country, as you people struggle with an attempt to bring this Federal fiscal mess under control, but it must be done in a much fairer way than has been suggested with the arbitrariness and capriciousness of Gramm-Rudman. It must be done in a more uniform way and everything must, and I emphasize "everything," must be laid out on the table so that it is all negotiable and it is all able to be dealt with.

The alternative is a total abrogation of your responsibility as elected officials. No one has ever campaigned for Congress in any party saying I will go there and I will pass a law that treats things in such a way to recognize that I don't have the guts to make the hard decisions. We all run for office saying we will make tough decisions, we will make choices and we will assume that responsibility.

Now the burden is finally laid on the doorstep of this Congress and the White House to assume that awesome responsibility and

make the decision that every Governor has to make every year, that is how much should the blind get, how much should the deaf get, how much should the mentally disabled get, how much goes to K–12 education, vocation, higher education, and all of these various special interest groups, constituencies, which make up as a whole the people of America, and the alternative to that is a rot that will start to infest in this country that will ultimately weaken us as bad as any mistake we would ever make in our national defense pursuits.

Mr. SLATTERY. Governor, thank you very much. Governor Clinton, did you have some remarks you would like to make?

STATEMENT OF HON. BILL CLINTON, GOVERNOR OF THE STATE OF ARKANSAS

Mr. CLINTON. Mr. Chairman, I would like to make just a couple of remarks, if I might, briefly, about the administration's proposed budget.

We stand together and in a bipartisan fashion on our own budget resolution which I think is at least as good a starting point for you as the administration's budget. I do think I would be remiss if I did not make some comments.

As Governor Janklow has said in great detail, since 1981 aid to State and local governments has been cut 30 percent in real terms. This administration's proposal would cut it another 19 percent in one year. If that is the basis from which you work, I think I should point out at least from my perspective, and I think I speak for a lot of the Governors, there are some particularly painful cuts in that proposal which I would like to document and explain very briefly.

One, of all the education cuts, the one that I feel is more indefensible is the chapter 1 proposal. Chapter 1 and before it title 1, is a successful Federal aid to education program if there ever was one. At a time when we are trying not only to upgrade all our education standards but include all children in that improvement, this is important.

Two, the Medicaid cut of $1.3 billion plus the cap would operate in a way that would be exceedingly burdensome to poor children who need medical care and I would argue to what I consider to be an emerging bipartisan consensus to do what we can to strengthen families in this country.

Let me just give you an example. The poorest State in our Nation is Mississippi. It also has the highest infant mortality rate. It also has a devastated economy that is so bad the Governor of Mississippi could not come to the Governors Conference. He is in the process of cutting his budget for the second time. The aggregate cuts will be well over $100 million. I have also done the same thing twice, not quite as much as him.

The way the administration's Medicaid proposal works on Mississippi would be to require the State of Mississippi against a background of terrible economic distress and low tax receipts, to increase by 28 percent its own expenditures next year to meet the same Medicaid levels it has this year. I submit to you that is an unconscionable result and inconsistent with the long-term objectives of the President toward welfare reform.

Third, a very small example in terms of dollars. The President seeks welfare reform but proposes to eliminate the very small program which provides funds for experimental programs in the States for training women who are on welfare to get off welfare.

The Washington Post has been full of stories in the last week about several States which have been mentioned, one of which was mine. People trying to successfully train and enable women to go back to work. That is the sort of thing that I think you need to look at very closely. Your judgment and your staff work on that will be better and in more detail than ours.

It seems to me that a lot of these proposals are not defensible.

I sympathize with the Congress for enacting Gramm-Rudman as a Democrat because I think you need some sort of framework to mandate deficit reduction targets. I believe that most thoughtful people on both sides of the aisle never meant for an automatic mechanism to make decisions that you would make, but simply meant to force your decisions within a narrower framework.

We will do everything we can to support you. We would like to stand on our budget position. If you do make decisions with reference to the administration's budget, I would plead with you to take a hard look at those that affect the children and the future of this country.

Thank you very much.

Mr. SLATTERY. I thank all of you for appearing here today and appreciate your testimony.

In the conversations that you have had among the Governors, when the question of revenues came up, what kind of revenues were you looking at? I am assuming that you recognized there is some need as some of your statements would tend to indicate, there is some need for additional revenue. What kind of revenue options were you all looking at? Oil import fees? Cigarette taxes? What kind of things were you looking at?

Mr. CARLIN. We never took a detailed look, quite frankly. I chaired the Governors when we put through this resolution and it was difficult enough to get them to agree that revenues should be considered, much less try to get into the details of what specific proposals. We have some guidelines that may be helpful. We are very sensitive to any discussion you might have that would move into the State and local area, for example, a value added through sales tax.

Obviously we know that even if you include revenues, you are going to ask us to be doing more. You only complicate it if you likewise get into our areas. You dominate an income tax. It is the logical area to stay. It is not a policy of the NGA but the oil import tax makes a lot of sense. I personally could support it. I think there are a variety of choices and adjustments that you can make to secure some revenue to be a part of a package to make the whole budget a little more palatable. We did not put a tax measure together because quite frankly, there are too many variables that would make it almost impossible, particularly given the time we have to limit ourselves to in terms of addressing resolutions dealing with national issues.

Mr. SLATTERY. As you all know, and just for the record, the fact of the matter is that the President has said Social Security is off

the table and he has also said taxes are off the table. You can imagine the kind of bind that puts you in, in the position of being in the Congress. What we are then left with is the responsibility to reach the $144 billion target for 1987 within the options that are remaining. Then you just talk about how much you can reduce the Pentagon request and what you are going to do with the money you saved by reducing Pentagon increases and foreign aid proposed increases, what are you going to do with that money, and where are you going to find other savings.

I would point out to you that our options as a Congress are dramatically limited. I would also observe that I doubt if many of your legislatures have passed tax increases over your vetoes recently.

Mr. JANKLOW. Mr. Chairman, if I might, we at least ascribe to the general premises that the executive proposes and the legislative disposes. I realize that things don't always happen very well over the objection of the executive branch. However, part of the problem that got us into this box was a game frankly played between the political parties. Is Social Security touchable or isn't it? It was more touchable to one party than another party, recognizing that people cross boundaries on it.

Is national defense touchable or isn't it? Recognizing that may cross boundary lines but it is more untouchable to one party generally than it is another. It is those types of things and everybody talking about a safety net and then we argue how high should the safety net be for the trapeze artist, should it be a high one, low one or medium sized one.

The point is that a certain amount of partisanship has boxed everyone into a corner from which they honestly don't feel they can extricate themselves, and maybe what the answer is, is instead of going into smoke filled room, go into one with out lights and nobody knows what corner they are in and start over and just say, it is all on the table and work from that premise.

Obviously if we continue to have the untouchables at the White House and other untouchables in the Democrat House and other untouchables in the Republican Senate, the bottom line is nothing is ever going to be accomplished of substance.

Mr. CLINTON. May I just make one comment? We were sent here with a resolution which has been amended. I just realized none of us had mentioned one point which was raised by one Governor on behalf of three in our conference this year.

At least three States, Massachusetts, New York, and Colorado, has reaped enormous revenue windfalls by stiffening enforcement of tax laws after a brief amnesty period. Governor Dukakis is our lead Governor on this issue and had the National Governors Association do some research which indicates that in the last 20 years, voluntary compliance ha dropped from 94 to 81 percent, that every percent loss is $5 billion to the Treasury and it might be that the cheapest way to raise more money would be to dramatically increase enforcement of existing tax laws after some sort of amnesty period that would be very well publicized along the lines that the States which have complex growing societies with relatively high taxes have followed.

It won't work in every State but it might work for the country. It is at least something you ought to check out, it seems to me, given

the circumstances you face. I would be remiss if I didn't raise it on behalf of the Governors who had done this.

In the last few weeks, New York has gotten $360 million which is a pretty good chunk of change in an amnesty program, from 145,000 taxpayers, who basically admitted they had been successfully cheating on their taxes and not paying what they owed.

It might be something that the House could initiate some action on which would really bear some fruit. Reduction of IRS forces and audits in the last few years has obviously complicated the problem. You might be able to genuinely raise some more money in a hurry. Of course, that kind of money raises the base for the future.

Mr. SLATTERY. Mr. Chairman, I would observe that my time has expired.

The CHAIRMAN. Thank you, Mr. Slattery, for taking the chair. Governors, let me apologize for my late arrival. However, I do have your testimony. It will be read in its entirety. I have been closely following your views on the budget process, and the President's budget, and what you think we ought to be doing if we are to maintain any semblance of an effective partnership with you at the State level.

At this time, the Chair recognizes the gentlewoman from Illinois, the ranking minority member, Mrs. Martin.

Mrs. MARTIN. We welcome the Governors' advice.

I am a little slow so I just want to be sure I understand this. You want us to put Social Security back on the table.

The President doesn't sign the budget. We want to put it back on this table, we can do this. It is not as if there is some law out there. I just want to be very sure I understand that in a bipartisan way, that is what you want. Is that correct?

Mr. SUNUNU. Let me explain it to you as carefully as I can.

The issue is simply in having taken the politically expedient route of removing it from the table, you have created a burden across the board. It has become apparent that it has become a game of political oneupsmanship. Who is going to take the lead and put issues back on the table that ought to be there.

The Governors thought that they provided a tool to the Congress by having the endorsement of the Governors that Social Security ought to be considered. We are constantly hearing from Members of Congress as they come down to chat with us, that we do not understand the political pressures under which they must operate, that we have no appreciation for the difficult lobbying that takes place down here.

Let me suggest to you that the Governors, back in the 50 States, live within that structure with the constituents on a day to day basis and that we are aware of political realities and the difficulties, and we too campaign. And in fact, I suggest to you, also, that probably in terms of the overall interaction between those constituencies it is much more frequent, much more intense, and much more personalized.

Social Security and Medicare are two very large numbers. There has to be a way, and a bipartisan way, a nonpolitical way, that we can meet our responsibilities. For you merely to stand on the political position that it is a difference of opinion between the President

and Congress right now and no one wants to yield is a disservice to the country.

Fifty Governors endorse a budget proposal that says Social Security need not be off the table. Fifty Governors endorse a proposal that say modest increases in defense are desirable in contrast with drastic cuts and that, within that context, 50 Governors endorsed the proposal that we are willing to take cuts in programs that we will then, as States, have to pick up.

I think, on balance, that is as broad a mandate as we possibly can give you. And to take little pieces of that and to suggest it means that we do not understand how difficult your task is, is unfair.

Mrs. MARTIN. Well, if I had suggested that, I would agree, it would. I was just asking a question, I thought. I wanted to be very sure I understood.

I certainly believe the Governors have difficult roles and face difficult constituents. In fact, Governor, I do not know of anyone here that suggests you do not have difficult jobs and do not face them. And that some of us respected a great deal and were here last year and the year before, and the year before.

Mr. SUNUNU. I did not say it was a difficult job. In fact, this is the easiest job I have ever had.

Mrs. MARTIN. All I am asking is please, please do not accuse us—or me, I guess—of an intent that was not there and certainly a statement not made. That, I think, would be inappropriate.

I will repeat again, though, Congress can remove or put on the table. We do dispose, as you say. It is difficult political decisions to be made, and you make them, too. We all do.

And I have always admired people willing to take cuts in their own programs as you say your budget--which I will reexamine—sees fit to do.

But it seems to me if I, in any way, during that question made you assume I did not think you made difficult choices, I am sure I do not know how that would be construed, but I would hope that would not be it.

Let me followup for a minute. One of the requests you make, which is truly legitimate, is the timing. And that is across the board, whatever we come up, starts affecting. Now I do not know the historical perspective, Mr. Chairman, on why the States and the Federal Government are on different fiscal years any more than, frankly, in my State local governments and the State are in different fiscal years, and so are school districts.

Most of you here, who have been working on this, are going to try to get you an early determination so you can know what you are going to have for your States.

How difficult will it be if the snapshot taken in August and that about 7 days that the Congress will have to act under Gramm-Rudman before there would be sequestration, could you say—and I realize this is leaping into the unknown—what increased difficulties, as a chief executive and on behalf of your legislatures, you would have if we delay until September those final decisions?

Mr. JANKLOW. Mrs. Martin, if I can answer just for myself. That is the kind of question that I think you might get 50 answers to. But let me briefly say this.

Our legislature is in session right now. There is a constitutional limit on how long they can be on session. They will adjourn this coming Saturday. They will recess; 3 weeks from now they will reconvene for 1 day. They are locking in the budget that will start July 1 for us.

When you recognize that the vast majority, or significant portion, of all of our budgets are federally driven, with respect to those programs, food stamps, Medicaid. Every State in the Union is on a different match ratio. Mine happens to be 66–33.

There are great differences in vocational rehabilitation. In our State it is 4 to 2 or 1 in 4, depending on how you look at it. And there are all these different match ratios. And we are appropriating the money now based on the match that we anticipate under the existing Federal law because no one has given a good printout yet on what the impact really is of Gramm-Rudman.

That is the reason that I emphasize that this uncertainty will kill us. And if we have to wait until September 1, which is 3 months into our fiscal year, we will have been doing ongoing State spending for a quarter of a fiscal year and our budget cuts, if you cut us let's say 20 percent in an area, will really have to be 20 percent plus 25 percent of that, which will be absolutely an unmitigated disaster.

The CHAIRMAN. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman, and I want to thank the Governors for what I think is an extremely helpful position paper and the statements you have made.

It does help move to do what we should be doing here, and we appreciate that.

All on the table, ought to be considered, those are kind of broad terms. What it really comes down to is Social Security, Medicare, and defense. You know that everything that is left is about the size of the deficit. So it is Social Security, Medicare, and defense.

Governor Janklow, would you be for freezing Social Security?

Mr. JANKLOW. I would be for freezing in the Government that does not have a natural growth factor except for additional people. If you add more people AFTC then you have to increase the budget because you cannot cut off the new ones.

But I personally am in favor, if it is fair, of doing it across the board for everybody in America where you have a nongrowth program. And I think the senior citizens, the elderly of America, would accept that if they thought they were being treated fairly. Part of the problem is every time a deal is cut in Washington somebody gets the shaft out there, so nobody wants to be part of any new deals.

Mr. LOWRY. Right; and the shaft comes right down to where you are. That is really true. You are really on the home front, we know that, you and the mayors.

So freeze COLA. I mean, demographics yes, but freeze the COLA.

Mr. JANKLOW. That is just one of them. I would say freeze everything and start from there. If you just froze everything and started from there, if you extended out for a short period of time some of the weapons procurement programs that you have that—instead of doing something in 48 months it took the 60 months, it would

make a phenomenal difference in terms of what you are dealing with on a year to year basis.

All I am saying is I do not think anything is untouchable in a democracy. Nothing should be carved in granite because we face new circumstances every year and old Congresses and old Governors and old legislatures and old Presidents should not bind future ones forever because of their good deeds or their misdeeds.

Mr. LOWRY. So freeze Social Security COLA on all recipients?

Mr. JANKLOW. I did not say that. I said that would be one of the things. You keep asking me that and I am going to keep giving you the same answer back.

Mr. LOWRY. But that is the big one. You have got COLA and defense. I am going to ask next on defense.

Mr. JANKLOW. You have got a whole host of other entitlement-type programs, too.

Mr. LOWRY. If you are talking about dollars and we are freezing all the rest, frankly it is just the vets and Social Security. I mean, the only thing we keep letting out of the freeze are the veteran programs and Social Security. We freeze the rest, Federal retirees, right down the line.

So it is Social Security; just freeze the COLA on Social Security.

Mr. JANKLOW. But you can go beyond that, Congressman, and you can put some indirect progressivity in maybe a taxing of the benefits so that those that really do not need it. I mean, we do have some folks in this country that retire on five digit benefits. And increase that progressivity in that tax structure there so that you can get a little bit back that way.

And I think that would be perceived as a fairness aspect.

Mr. LOWRY. Absolutely. Very good point. I appreciate that.

Mr. JANKLOW. And that is something Congressman Daschle from my State, who is in the other party, and I both agree on and that is a freeze across the board and work from there. At least you would stop it in place while you have time to work and it would not keep growing by $20 or $40 billion a year and up.

Mr. LOWRY. Governor Carlin, as I read your paper, it says on national defense limited to 1986 levels plus inflation. How come you want to give defense inflation?

Mr. CARLIN. The feeling was that that was a reasonable goal. Just to have a flat freeze and not allow for inflation, you know, you might be able to justify it, but given what the President was coming from, given the fact that in our association we wanted—there is no use running up a resolution you cannot get support for. We wanted the Governors, in a bipartisan way, to be supportive. This is what we came out with.

And quite frankly, it has strong support because we had some of that give and take. We were able to get revenues on the table by being maybe middle of the ground on defense. We got the COLA's included, including Social Security, but it had to be—just as you are going through your process—we had to balance various interests.

Mr. CLINTON. I also think you have to take all of our statements on defense not so much in a context of taking or not taking political heat but as a reflection of our understanding the fact that you

have facts that we do not. That is really not an area within our expertise.

We may all have well informed opinions about whether you should give military aid to the Contras, that is something you read in the newspapers and know. But basically, if you are a busy person, it is hard to be an expert on the defense budget as a whole.

I think that we have always that respectfully, we should be a little gingerly there.

Mr. Miller, the Budget Director, testified before us at the White House a couple of days ago that there were $299 billion unexpended in the budget authority of the Defense Department which he said were either pipeline dollars or might be needed for other purposes.

He was very candid about it, which I appreciated, but there may be options there that we are just not in a position to make judgments on.

Mr. LOWRY. The obvious reason for the question is for that, trying to reach this compromise. I mean, freezing Social Security COLA and giving inflation for defense is an obvious point that jumps right out in the paper, and that is why I am asking the question.

Mr. CLINTON. One of the things that I do not know—I do not know what the numbers are, you might be able to modify the Social Security COLA and modify inflation. You have got all kinds of options that—Chairman Gray and I were on McNeil-Lehrer the other night and that is the point I tried to make. The Governors want to give you enough flexibility to say you can cut our programs, too, and we will support you. But listen to our priorities and let us try to help you and raise the flag when you cut things that we can live with. We have tried to do it in the past.

Mr. LOWRY. I again want to compliment you, I think, for a very helpful paper. And I mean that.

The CHAIRMAN. The gentleman from Colorado, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

I would just simply like to add my thanks to the Governors for a very responsible—actually rational statement on the budget. We do not really see very many of those.

I might suggest that we do have a number of groups working on a freeze budget and it has been introduced in the House. I am not sure we have a majority of the votes for that, but I think your sentiment is reflected by many Members of the House and the Senate.

It strikes me that you, who make up representation for both parties, have experience in dealing with budgets, seem to have come up with a pretty rational sound decision that looks to me like it gets us to where the numbers ought to go. The Representatives from your States, probably reflecting similar party breakdown, seem totally unable to come up with numbers that reflect an ability to get to that same place.

What do you all see as necessary to bring Congress around to a rational policy? More specifically, what would your feelings be with regard to a constitutional limit to provide some sort of limitation on spending?

Mr. CARLIN. What does it take? I think it would help if the President were a little bit more interested in the deficit issue. And I

think it would be very helpful if you would put the deficit and the budget ahead of tax reform, in terms of priorities this year.

And as to a constitutional change, we have in our resolution that and line item vetoes as reforms that you might consider. I personally would not want, at this juncture, for you to turn to that as the answer. My preference would be you deal with it and get the job done, and then in order to secure it for the future yes, consider the constitutional route.

As you are well aware, if the solution to the current crisis is the Constitution, you are going to spend years and my farmers and my small businessmen—particularly in rural towns—do not have years. Many of them are already out. They are going by the thousands and that is not a sensible solution. But we acknowledge that those types of changes might be helpful and that much of our courage and common sense may come from the fact that our Constitution require us to be fiscally responsible.

Mr. CLINTON. Just to follow up on that, in the aftermath of the 30-percent cut and aid to State and local governments and all the programs since 1981, 44 States have raised taxes. Not for new education programs, there has been a lot of that, but 44 had to raise taxes to replace programs or revenues.

So I think we are more turned toward this balanced budget environment because we have to live within it.

The second thing I would say is I think you did what you needed to do. You adopted, legislatively, the deficit reduction schedule embodied in the Gramm-Rudman-Hollings bill. Now I think everybody has reservations about the across-the-board cuts triggering and sort of giving up your responsibility. But frankly, that is the equivalent of a revenue stabilization act and it goes beyond what the Congress tried to do, I think, in the Budget Act of 1974 which—where you were trying to guarantee some responsibility, it did not work out so well.

And I think you did the right thing to adopt those deficit reduction targets and make them as mandatory as you constitutionally can. And I say that as a Democrat. I think you had to do it and I think it is now up to us and you to work it out.

Mr. BROWN. I appreciate that. I might just say, so you do not take our rhetoric around this town too seriously, I know we talked about we do not want to increase taxes, but tax revenue is up 50 percent since 1980. We have had a tax increase in 1982, and 1983, and 1984 and the President has recommended a $6 billion revenue enhancement, if that is the term, for this year. So at least in my own mind I am not convinced that our failure to raise taxes has been the problem.

Mr. SUNUNU. I want to emphasize what Governor Clinton, I think, was pointing out, that Gramm-Rudman-Hollings provided a framework. The beauty of Gramm-Rudman-Hollings, I think, is that you ought to then not let it trigger automatically and not take the easy way out, and ought to then address the issues and make some specific votes on specific pieces of change that, as a whole, make much more sense than the across the board.

I do want to go back to the general NGA policy which recognizes that if you go through all this agony once, you ought to at least have provisions in place that might assure that you do not have to

do it again for a long, long time. And that does address the constitutional question of a balanced budget and the line-item veto aspects. But those are long term procedural changes that I suspect by the time you can even nibble away at them, this issue will have to have been resolved, the deficit issue.

Mr. BROWN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Kansas, Mr. Slattery.

Mr. SLATTERY. Very briefly, Mr. Chairman, I just wanted to let the Governors know that there are some Members of the Congress that do believe that we should look at everything, including Social Security, and that we should look at revenues and that we do have a fundamental, moral obligation to pay our bills so that we do not pass on these bills to the next generation.

Maybe we are like the canaries that the miners used to let loose, you know, in the mines. I do not know what our political longevity will be like, but I just want you to know there are some people in the Congress that, frankly, are disgusted with the fact that in the last few years we have somehow gotten away from the mythology—if you will—that this Government has lived with for over 200 years.

And that is that in a democracy, after the elected representatives decide how they are going to spend the money, that they somehow muster the courage to pay for the money that they have decided to spend.

Now we have had a much-maligned period of tax and spend, only to be replaced by a period of spend and borrows, which is even more irresponsible than tax and spend. But the good news is that I think that we are about ready to end the ridiculousness of the last few years and we are going to move beyond this era of thinking that somehow we are going to grow out of $200 billion deficits and they will disappear like the work of the magic dragon or something, and we will get on with some degree of fiscal responsibility here in Washington.

I will tell you that last year when we had an opportunity to vote on this issue, there were 56 people out of 435 in the House of Representatives that were willing to deal with revenues, Social Security entitlements and deal with it in a sensible way. I think that number has dramatically increased, and we will find out very soon.

But there are some missionaries here. There are some, you know, proverbial canaries loose, I guess you might say, and we will see what happens.

Good to have you here today, and I appreciate your sensible approach to this problem.

The CHAIRMAN. Governors, let me ask a couple of brief questions. I apologize for my late arrival, but I want to just ask a couple of questions.

Governors, in your State, do you have the ability to veto legislation?

Mr. CARLIN. Yes; everybody but North Carolina, I think.

Mr. CLINTON. Line-item veto, you mean?

The CHAIRMAN. No, I am just saying veto, general veto.

Mr. CLINTON. Yes.

Mr. CARLIN. General veto, I think everybody but North Carolina.

The CHAIRMAN. What about with regard to revenues? If you veto a revenue bill, does it take more than a simple majority to override your veto?

Mr. CARLIN. Two-thirds.

The CHAIRMAN. Governor Janklow?

Mr. JANKLOW. In South Dakota it takes two-thirds to raise additional revenue, and it takes two-thirds to override a veto, so it is a two.

The CHAIRMAN. So it is the same. What about you, Governor Sununu?

Mr. SUNUNU. Simple majority with my signature can raise the revenue. It takes two-thirds to override a veto.

The CHAIRMAN. Governor Carlin?

Mr. CARLIN. The same.

The CHAIRMAN. Governor Clinton?

Mr. CLINTON. In our State it takes three-quarters of the vote to raise income tax or gas tax, a majority to raise the sales tax. But any veto can be overridden by a majority, even a three-fourths veto.

The CHAIRMAN. Now you have stated that revenues ought to be on the table. Those of you who have the veto ability, because you have to get more than a majority, in your experience, does the State legislature override your veto?

Mr. CLINTON. Mine did once, but it was because they did not have to have the three-quarters vote.

The CHAIRMAN. No, I am talking about those with the three-quarters, though, or two-thirds.

Mr. JANKLOW. As you approach the end of your term they are more susceptible to do it. I find it more often this year than I have in the past.

The CHAIRMAN. Have you had the situation on a tax matter, Governor, to your knowledge? Has this happened to you or any other Governor where they vetoed a piece of legislation and more than a simple majority was needed to override you and they were able to do that?

Mr. JANKLOW. Let me respond this way, Mr. Chairman. In my State, most of the enhancements, or frankly, tax increases have taken place since I have been Governor, I have proposed. I have raised gas taxes a nickel. I have broadened the contractor's excise tax. One year we raised the sales tax 25 percent to pay cash and buy a railroad because we did not want a bond, and paid for it.

But generally, the increases in taxes that have come since I have been Governor are to keep our budget in balance, I have proposed it to take everybody else off the hot seat and then they could blame Janklow for it. But meanwhile, we got the revenues we needed to run the Government.

Mr. SUNUNU. I think in the budget package I had to put into, address a fiscal crisis I inherited, the legislature was convinced that I had made all the cuts I could possibly do and supported the revenue increase. They also supported the tax decrease that we proposed this last time.

So generally, the response has been, if I send to the legislature a package that they feel comfortable with, they have supported it with the changes that addressed, from their point of view, a slight

altering in priorities. But, for the most part, they have been responsive.

The CHAIRMAN. I asked the question because here on Capitol Hill there has not been a tax increase without a President's support for 30 years. Therefore, even if Pete Domenici and I should agree that there ought to be revenues on the table, it cannot happen without the two-thirds majority required to override a Presidential veto.

In your experience, either personally or in your history and knowledge of the governorship, did you know of a time when the State legislature, overrode the veto of the Governor against revenues?

Revenues on the table is not a function of the legislative body, even though theoretically and constitutionally it does not work that way here in Washington. The President must say he is willing to consider revenues and then we begin to argue about what kind, gas tax, sales tax et cetera.

Although last year, Senator Domenici very clearly tried to put revenues on the table, it did not occur.

Governor, you were trying to say something?

Mr. JANKLOW. Yes, Mr. Chairman. It is my understanding that the Constitution says, in the literal sense, that revenue enhancing measures are raised in the House, start in the House of Representatives. Now I realize there are practical problems, but I would suggest this. That when I propose a tax increase in my State, if the legislature does not go along, at least we know who did not go along.

And I would also submit that if enhancement is to part of, or expansion, or increase, whatever you want to call it, it is to part of any solution to America's problems, if everybody did what they thought was right and the President were to veto it, then at least we all know who voted no at what time and who to blame for it. But right now, we all get to blame each other, and nobody is responsible for it.

The CHAIRMAN. Well, I would just simply say, Governor, that is not the way it works here. And you know, if you should be successful in your endeavors, you will find that out once you get here, if you get here. But it does not work that way, even though the Constitution says that it starts, theoretically, in the House. The reality is, the practicality is, that it starts when a Chief Executive says, look, I will consider revenues.

And I think we are being a little simple-minded if we think we can take the experience of Harrisburg in my State and apply it to Washington and say, you know, because the constitution of the commonwealth says one thing, it should be done that same way in Washington.

Let me ask one last question of all four for a quick response, because we are late. Based on what you have heard out there, reactions to the President's budget—not to deficit reduction. Because I think all of us here in Washington want strong deficit reduction. But to the policy choices—12 percent increase in defense, elimination of 40 programs—how do your constituents, who are also our constituents, feel about those priorities and policy choices? Could you give me in a 10 second yes, no, or maybe?

Mr. CLINTON. I think the people who know what is in there and have an opinion, do not like the education cuts, do not like the Medicaid cuts, and do not like the farm cuts in my State. That is what the people say.

I think that there is profound concern that maybe the administration has gone overboard. And I live in a pretty conservative State where we supported a lot of these cuts, and where a lot of the Democrats have not criticized them all. But there is a strong feeling that it imperils the—some of the cuts imperil the domestic security of the country. That they have just gone overboard.

I believe that is a fair reading.

The CHAIRMAN. Governor Carlin.

Mr. CARLIN. I would agree with that. I think the personal support of the President, but not for the budget that was sent. A sense that it is too high on defense and too short in other areas. And there has got to be more balance and fairness.

The CHAIRMAN. Governor Sununu.

Mr. SUNUNU. You are liable to get a partisan distribution on this answer. In our State, I think the support is there. We have made a commitment at the State level to pick up any of the shortfalls and be responsive to the programs.

I think we can do that, and I think that that is the message that we have been trying to convey. In those States where that can be done, you are going to get a constituency that is positive.

The CHAIRMAN. So you are saying that you could——

Mr. SUNUNU. They support the budget.

The CHAIRMAN [continuing]. Support the President's priorities exactly as they are?

Mr. SUNUNU. That is correct.

The CHAIRMAN. Thank you.

Mr. JANKLOW. I think there is a recognition in my State that every year the President sends a budget to Congress, it is dead on arrival. When the Congress sends it back, they have generally appropriated more money than he asked for, yet they want him to raise taxes, and they do not want to assume the responsibility for starting it even though they increased their expenditures.

And I would probably agree with Governor Clinton, Governor Carlin and Governor Sununu. We are prepared to pick up some of the slack if you will take the regulatory arbitrary controls off us. And at the same time, these human things that involve people, development and agriculture have got to be looked at in a different, more uniform, more fair light.

The CHAIRMAN. Because there is a lot of misinformation, I will conclude with the following comment.

First of all, the President submits a budget because it is his economic prescription, and it is his way of dealing with the economy. This chairman has not said that it is dead on arrival. I think I am the chairman of the House Budget Committee. I do not know what anybody else says. I know the Speaker of the House has not said it is dead on arrival. This year we are traveling down a new road, Gramm-Rudman, and so it is very much alive. I suspect that there will be an opportunity for Members to vote on the President's budget.

But I would also want to make it very clear, as David Stockman has pointed out, if you add up the requests of the President for the last 5 years, and add up what we have done in Congress, contrary to popular mythology, you will find that we gave the President less than what he asked for over the last 5 years.

I want to make that slight correction, because that is what the record shows. And even his former budget director has made that clear.

I think it is interesting to hear your testimony. I am particularly delighted for the candor with which you approach the subject, particularly with regard to the President's priorities and his choices. It is extremely helpful to us.

This week we will conclude our hearings and begin the process of putting together a deficit reduction package. It may be exactly like the President's, or it may not be exactly like the President's. Certainly your testimony has been very, very constructive and helpful to us to determine what those priorities are.

Mr. FROST. Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. FROST. I would just like to echo, particularly to the Governor from South Dakota, what the chairman said. In the aggregate, when you add it all up in the last 5 years, in the aggregate Congress has appropriated less total dollars than the President has requested.

Now the President has not gotten what he wanted in defense, but that is not the point. In the total aggregate, Congress has appropriated less dollars than President Reagan requested over the last 5 years.

Mr. JANKLOW. Mr. Chairman, but I think it is appropriate that we look at every year at a time. You can always take an aggregate of a multiple of years, but in fairness to the President, in fairness to this Congress and everybody else, and the American people, you look at every budget every year.

Mr. FROST. And if you look at each individual year, you will find that in virtually every year, Congress in the aggregate of all categories of the budget has appropriated less than the President requested.

The CHAIRMAN. I would just correct—I would answer the Governor's statement by pointing out that over the last 5 years there has been only 1 year out of 5 where Congress appropriately slightly—slightly more than what was asked. So not—just 1 out of 5.

I would also submit to you, Governors, that this fact is a fairly well known one, which David Stockman clearly articulates.

I thank you for your testimony. Thank you for coming. Again, I apologize for not being present at the beginning.

Mr. CARLIN. Thank you, Mr. Chairman.

The CHAIRMAN. The committee will now hear from the distinguished Chair of the Science and Technology Committee, the Congressman from Florida, Chairman Don Fuqua.

Chairman Fuqua, we want to welcome you to the Budget Committee. I am going to ask Congressman Lowry if he would assume the chair, because I have been called away to a meeting to discuss reconciliation and the possibility of resurrecting reconciliation and

coming to some agreement, which you know, is very, very important.

Please forgive me, Chairman, if I step out. However, I will carefully review the testimony. We look forward to working with you and your committee as we have done in the past to address the deficit reduction issue.

STATEMENT OF HON. DON FUQUA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA AND CHAIRMAN, SCIENCE AND TECHNOLOGY COMMITTEE

Mr. FUQUA. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you for the opportunity to testify before the committee on those programs and priorities that are reflected in the budget that are within the jurisdiction of the Committee on Science and Technology.

And before discussing the highlights within each of the agencies, I would like to begin by observing the general themes that are presented to all of us as we examine the civilian R&D budget and make decisions about it.

First of all, for each of the past few years there seems to be an increasingly and deeper understanding of how very important to our economy and long-term well-being the Federal support for basic science is. And I welcome this commitment and support, both on the part of the Congress and the administration.

The budget requests for the National Science Foundation, NASA, and the Department of Energy all reflect this understanding and continue this commitment. These dollars and this commitment are essential to keep this Nation on the competitive edge.

We have taken major steps, such as creating new engineering centers with NSF support, planning on new science projects such as the 1 and 2 gigaelectronvolt synchotron and continuous electron beam accelerator, and building an exciting program at several universities for supercomputer centers.

Second, the tragic accident of the space shuttle *Challenger* is causing the necessary reexamination of the programs, projects, and schedules in the budget as requested. Our more detailed submission reflects this additional dilemma for the administration and the Congress, which I hope can be resolved without a long and costly hiatus. Because of the leadtimes in acquiring another shuttle, if that is proposed, a supplemental will be the preferential course, in my view.

The third theme is the recurring problem presented by the administration's narrow view that energy programs are just not worthy of Federal support. Each year we are disheartened by the lack of support for these areas that offer great long-term promise, and each succeeding year the level of support dwindles even further.

Now I would like to say a few words and highlight each agency's budget.

The National Science Foundation fiscal year 1987 budget request shows an increase of 8.4 percent over the fiscal year appropriation. This budget would provide for growth in several key areas, such as the engineering research centers; advanced scientific computing;

biotechnology; global geoscience; and science and engineering education at all levels, precollege through graduate education, including new initiatives to increase the numbers of women and minorities in science and engineering careers.

Now I am pleased that the administration has proposed a modest increase in the NSF budget. This recognizes that a sustained Federal investment in basic research at our universities and colleges will yield the technical innovation that is required for our future economic competitiveness in world markets, and will train the next generation of scientists and engineers that our country needs so desperately.

The National Bureau of Standards fiscal year 1987 budget request shows a total that is equal to the fiscal year 1986 appropriation. However, when we examine the details of the budget we see that unique programs essential to national safety would be eliminated in order to accommodate several—and I must say worthy—initiatives which support rapidly emerging high-technology industries.

The programs that would be eliminated—the Center for Fire Research and the Center for Building Technology—play a major role in developing fire and building codes. I believe that we need to retain these vital functions and need to go forward with the high-technology initiatives.

I believe that a modest increase for this unique agency would be in the national interest, in terms of national safety, technological innovation, and economic competitiveness.

The President has requested $7.694 billion for fiscal year 1987 for NASA. However, this request was prepared before the January 28 *Challenger* accident. Since that time, NASA has made preliminary estimates that put the total impact of this loss at about $3 billion, including the orbiter, replacement items, and anticipated modifications.

Since there has been no decision on a replacement orbiter, I would ask for funding levels to be allocated as requested in the committee's view and estimates submitted to the Budget Committee today. This allocation of funding will allow us to begin to plan for the long lead items that will be necessary, regardless of the final decisions that are made, in order to maintain the U.S. lead in space.

The President remains committed to a manned space station and has included funding in his fiscal year 1987 budget request to begin phase C and D, the development stage of the space station. Negotiations are currently underway with other countries to enhance the U.S. commitment in the space station.

A major new research initiative proposed by the President and under review by the Science and Technology Committee is the transatmospheric vehicles, or the Orient Express as it has been called. This joint NASA/DOD Research and Technology Program will explore new approaches for cost-effective hypersonic vehicles for flight in the atmosphere and for access to space.

Since NASA had no new science starts for fiscal year 1986, we are pleased to note that the President has proposed one new initiative in the science area, the ocean thermal experiment called TOPEX. This mission will permit oceanographic studies contribut-

ing to a better understanding of the effect of global ocean circulation on the Earth's climate.

In the administration's proposal, a major program, the Advanced Communications Technology Satellite [ACTS], was cut from the budget—actually axed from the budget.

This had originally been a congressional initiative and will be carefully reviewed by the Science and Technology Committee in its authorization hearings.

The FAA's research expenditures are fully funded by aviation users through contributions to the airport and airways trust fund. In recent years, the trust fund has enjoyed a substantial surplus, currently over $7 billion. Yet despite this, the administration has refused to request budget authority, as authorized by Congress. For fiscal year 1987, the Congress authorized $193 for research, but the administration requested only $134 million, a shortfall that will delay badly needed modernization of air traffic control systems.

I am concerned that refusal to spend money that airline passengers have contributed for the purpose of developing a safer system is bad faith on the part of the Government. Although a trust fund surplus does make the deficit look a little better, spending these funds to improve air safety is a higher priority.

The Department of Energy budget request is reflective of major policy imbalances. For these energy technology R&D areas traditionally supported by the Congress, drastic cuts are proposed. For example, some changes from the fiscal year 1986 appropriation levels are: Conservation, a 58-percent reduction; fossil, a 56-percent reduction; solar, including geothermal, a 47-percent reduction; and supporting research, a 6-percent increase. The committee intends to maintain the levels of program efforts at a more constant rate than is reflected in the dramatic reductions proposed by the President's budget.

The science programs in the DOE, however, enjoy significant increases in total dollar funding requests. In general science, additional funds are provided to increase facility utilization, to bring two new facilities online, and to start construction for the continuous electron beam accelerator [CEBAF] at a total of $25 million.

The President's fiscal year 1987 request of $273.8 million for DOE environmental programs is needed to provide for the environmental and safety appraisals of many aging DOE facilities and strengthening of the environment safety and health programs to maintain DOE's long-term research on the biological and environmental effects of energy-related technologies.

There would be four major impacts of the President's proposed 25-percent reduction of the budget for the National Oceanic and Atmospheric Adminstration [NOAA].

First, all funding for commercial land-remote sensing would be terminated. As a result, this promised new space-based industry would be abandoned to the French, who launched a competing satellite just 4 days ago, and also to the Japanese.

Second, only one polar orbiting satellite would be funded. Elimination of the second polar orbiter greatly increases the risk of long gaps in satellite coverages, gaps that could seriously degrade the art of weather forecasting and which would deprive over 120 nations of timely weather information.

Third, over one-third of NOAA's research programs would be eliminated. NOAA conducts both basic and applied research on weather forecasting, fisheries management, and important national and international environmental issues including acid rain and the greenhouse effect and marine pollution.

Fourth, the proposed budget reductions would continue a 5-year trend toward depletion of personnel levels in the National Weather Service. Committee hearings have indicated that the Weather Service offices are already stretching to the breaking point, particularly in times of severe weather.

In the Environmental Protection Agency, the effect of the President's proposed budget for 1987 on EPA R&D reverse the trend toward the gradual restoration of adequate research funding to support the Environmental Protection Agency's important regulatory responsibilities. Despite general recognition that EPA research funding has not been sufficient, particularly in the complex areas such as hazardous waste, toxic substances, and biotechnology, the administration has proposed a $30.8 million reduction from the fiscal year 1986 appropriation level for fiscal year 1987. Above the fiscal year 1986 Gramm-Rudman cuts, the budget would cut an additional $16.8 million for fiscal year 1987. Overall, the total funding would be reduced by 9.5 percent from the fiscal year 1986 appropriation levels.

For example, the administration proposed cutting more than $5 million from its long-range research programs which support high-quality, peer-reviewed university research. This program has consistently provided the agency with expertise found in our Nation's leading universities and has been highly valuable in improving the understanding of basic environmental processes which we need to make environmentally sound and economically efficient regulatory decisions.

Other reductions, while not as large, will affect the ability of the agency to provide the needed scientific support for regulatory decisions in a timely manner. We need to recognize that if we expect the EPA to carry out effectively the many laws which have been delegated to it by Congress, we must be willing to provide it with the tools it needs to do the job. The administration's proposed fiscal year 1987 budget does not do that.

Mr. Chairman, that concludes my remarks, and I'll be pleased to answer any questions that you might have regarding any of those items within the jurisdiction of the Science and Technology Committee.

[The prepared statement of Mr. Fuqua follows:]

Prepared Statement of Hon. Don Fuqua

Mr. Chairman. Thank you for this opportunity to testify before the Committee on those programs and priorities reflected in the budget that are within the jurisdiction of the Committee on Science and Technology.

Before discussing the highlights within each of the agencies I would like to begin by observing the general themes that are presented to all of us as we examine the civilian R&D budget and make decisions about it.

First of all, for each of the past few years there seems to be an increasingly deeper understanding of how very important to our economy and long-term well being the federal support for basic science is. I welcome this commitment and support both on the part of the Congress and the Administration. The budget requests of NSF, NASA, and DOE all reflect this understanding and continue this commitment. These dollars and this commitment are essential to keep this nation on the competitive edge. We have taken major steps, such as creating new engineering centers with NSF support, planning on new science projects such as the 1 and 2 GeV synchotron and the Continuous Electron Beam Accelerator, and building an exciting program at several universities for supercomputer centers.

Second, the tragic accident of the Space Shuttle Challenger is causing the necessary re-examination of the programs, projects and schedules in the budget as requested. Our more detailed submission reflects this additional dilemma for the Administration and the Congress which I hope can be resolved without a long and costly hiatus. Because of the lead times in acquiring another Shuttle, if that is proposed, a supplemental will be the preferred course, in my view.

The third theme is the recurring problem presented by the Administration's narrow view that energy programs are just not worthy of federal support. Each year we are disheartened by the lack of support for these areas that offer great long-term promise, and each succeeding year the level of support dwindles even further.

Now I would like to say a few words to highlight each agency budget.

NATIONAL SCIENCE FOUNDATION

The National Science Foundation FY 1987 budget request shows an increase of 8.4% over the FY 1986 appropriation. This budget would provide for growth in several key areas, such as: the engineering research centers; advanced scientific computing; biotechnology; global geosciences; and science and engineering education at all levels -- pre-college through graduate education, including new initiatives to increase the numbers of women and minorities in science and engineering careers.

I am pleased that the Administration has proposed a modest increase in the NSF budget. This recognizes that a sustained federal investment in basic research at our universities and colleges will yield the technological innovation that is required for our future economic competitiveness in world markets -- and will train the next generation of scientists and engineers that our country needs so desperately.

NATIONAL BUREAU OF STANDARDS

The National Bureau of Standards FY 1987 budget request shows a total that is equal to the FY 1986 appropriation. However, when we examine the details of this budget, we see that unique programs essential to national safety would be eliminated in order to accommodate several and -- and I must say worthy -- initiatives that would support rapidly emerging high technology industries.

The programs that would be eliminated -- the Center for Fire Research and the Center for Building Technology -- play a major role in developing fire and building codes. I believe that we need to retain these vital functions and we need to go forward with the high tech initiatives. I believe that a modest increase for this unique agency would be in the national interest -- in terms of national safety, technological innovation and economic competitiveness.

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

The President has requested $7.694 billion for FY 1987 for NASA. However, this request was prepared before the January 28 Challenger accident. Since that time, NASA has made preliminary estimates that put the total impact of this loss at about $3 billion --including the Orbiter, replacement items, and anticipated modifications. Since there has been no decision on a replacement Orbiter, I would ask for funding levels to be allocated as requested in the Committee's views and estimates submitted to the Budget Committee today. This allocation of funding will allow us to begin to plan for the long-lead items that will be necessary regardless of the final decisions that are made in order to maintain the U.S. lead in space.

The President remains committed to a manned Space Station and has included funding in his FY 1987 request to begin Phase C/D, the development stage of the Space Station. Negotiations are currently underway with other countries to enhance this U.S. commitment to the Space Station.

A major new research initiative proposed by the President and under review by the S&T Committee is the transatmospheric vehicle, or the "Orient Express" as it has been called. This joint NASA/DOD research and technology program will explore new approaches for cost-effective hypersonic vehicles for flight in the atmosphere and for access to space.

Since NASA had no new science starts in fiscal year 1986, we were pleased to note that the President has proposed one new initiative in the science area--the ocean topography experiment (TOPEX). This mission will permit oceanographic studies contributing to a better understanding of the effect of global ocean circulation on the Earth's climate.

In the Administration's proposal, a major program, the Advanced Communications Technology Satellite (ACTS), was cut from the budget. This had originally been a congressional initiative and will be carefully reviewed by the S&T Committee in its authorization hearings.

FEDERAL AVIATION ADMINISTRATION

The FAA's research expenditures are fully funded by aviation users through contributions to the Airport and Airways Trust Fund. In recent years, the Trust fund has enjoyed a substantial surplus currently over $7 billion. Yet, despite this, the Administration has refused to request budget authority as authorized by the Congress. For FY 1987, the Congress authorized $193 million for research; but the Administration requested only $134 million, a shortfall that will delay badly needed modernization of the air traffic control system.

I am concerned that the refusal to spend money that airline passengers have contributed for the purpose of developing a safer system is bad faith on the part of the government. Although a Trust Fund surplus does make the deficit look a little better, spending these funds to improve air safety is a higher priority.

DEPARTMENT OF ENERGY

The Department of Energy budget request is reflective of major policy imbalances. For those energy technology R&D areas traditionally supported by the Congress, drastic cuts are proposed. For example, some changes from the FY 1986 appropriation levels are: Conservation, 58% reduction; fossil, 56% reduction; Solar, including Geothermal, 47% reduction; Supporting Research, 6% increase. The Committee intends to maintain the levels of program effort at a more constant rate, than is reflected in the dramatic reductions proposed by the President's budget.

The science programs in the DOE, however enjoy significant increases in total dollar funding requests. In General Science, additional funds are provided to increase facility utilization, to bring two new facilities on line, and to start construction for the Continuous Electron Beam Accelerator Facility (CEBAF) at $25 million.

The President's FY 1987 request of $273.8 million for the DOE environmental programs is needed to provide for environmental and safety appraisals of many aging DOE facilities and strengthening of the environment, safety, and health programs and to maintain DOE's long-term research on the biological and environmental effects of energy-related technologies.

THE NATIONAL OCEANIC AND ATMOSPHERIC ADMINISTRATION

There would be four major impacts of the President's proposed 25 percent reduction in the budget of the National Oceanic and Atmospheric Administration (NOAA). First, all funding for commercial land remote-sensing would be terminated. As a result, this promising new space-based industry would be abandoned to the French (who launched a competing satellite just four days ago) and to the Japanese. Secondly, only one polar-orbiting weather satellite would be funded. Elimination of the second polar-orbiter greatly incrsases the risk of long gaps in satellite coverage -- gaps which would seriously degrade the art of weather forecasting and which would deprive over 120 nations of timely weather information.

Thirdly, over one-third of NOAA's research program would be eliminated. NOAA conducts both basic and applied research on weather forecasting, fisheries management, and important national and international environmental issues including acid rain, the "greenhouse effect", and marine pollution. Fourth, proposed budget reductions would continue a five-year trend toward depletion of personnel levels in the National Weather Service (NWS). Committee hearings have indicated that NWS offices are already stretched to the breaking point, particularly in times of severe weather.

ENVIRONMENTAL PROTECTION AGENCY

The effect of the President's proposed FY 87 budget for EPA R&D reverses the trend toward the gradual restoration of adequate research funding to support the Environmental Protection Agency's important regulatory responsibilities. Despite general recognition that EPA's research funding has not been sufficient, particularly in the complex areas such as hazardous waste, toxic substances and biotechnology, the Administration has proposed a $30.8 million reduction from the FY 86 appropriation levels for FY 87. Above the FY 86 Gramm-Rudman cuts, the budget would cut an additional $16.8 million for FY 87. Overall, total funding would be reduced 9.5 percent from the FY 86 appropriation levels.

For example, the Administration proposes cutting more than $5 million from its long-range research program which supports high-quality, peer-reviewed university research. This program has consistently provided the Agency with expertise found in our nation's leading universities and has been highly valuable in improving the understanding of basic environmental processes which we need to make environmentally-sound and econmically-efficient regulatory decisions.

Other reductions, while not as large, will affect the ability of the Agency to provide the needed scientific support for regulatory decisions in a timely manner. We need to recognize that, if we expect the EPA to carry out effectively the many laws which we have delegated to it, we must be willing to provide it with the tools its needs to do the job. The Administration's proposed FY 87 budget does not do so.

Mr. LOWRY [presiding]. Chairman Fuqua, thank you for your excellent statement and your outstanding leadership in this entire area.

Would you just go over again how you think, within the budget, realizing the timing constraints we're under trying to meet the deadlines set forth by Gramm-Rudman, that we ought to approach the Challenger question? How within the budget? Should we just ignore it at this time? Would you just clarify that a little more?

Mr. FUQUA. The administration, as of noon today, had not made a decision. That, I have been informed, is an interagency review.

As I have indicated in my statement, I think that we will need, at an appropriate time—my personal view is to go with a supplemental authorization and appropriation.

There will be some savings as a result of the shuttle programming being down. For instance, for about 4 months, there will be about a $60 million savings. If we go to 12 months, there will be about $140 million savings.

But let me point out on the other side of the ledger that there are costs involved, too. We still have the people involved. For instance, the Galileo Mission is one that was scheduled to be launched in May of this year, which will be a major scientific project, to Jupiter.

We also have the Ulysses project, which is another scientific project. Both of these were scheduled to be launched this year. They will be delayed. The window only comes open once every 13 months, so that would be delayed until June of next year.

They must store those. There are certain costs involved with the people associated with those programs, and manpower costs are a big item. You can have some reductions, but you can't have a lot. For instance, the big external tank that goes on the shuttle is still under fabrication. Orders have been made. That line will continue, but it can be slowed down maybe later in calendar year 1987 or fiscal year 1987 and 1988 to catch up with the demand for the launch.

So right now, as I mentioned, there's probably a replacement cost of approximately $3 billion. Now that's over several years. There will be a need to be approximately $200 to $300 million this year, budget impact for a replacement orbiter. We have a number of spare parts worth almost one-half billion dollars that are available

to be used in the fabrication of a new shuttle, but in order to get that line going again and to replace those spare parts at the end of the program will total, in modifications that have to be made to the—which appears to be the solid rocket booster, will also be included in the total $3 billion figure.

Mr. LOWRY. Mr. Chairman, when you said "estimated," of course, those are extremely difficult questions right now.

Mr. FUQUA. Yes, they are.

Mr. LOWRY. The estimated $200 to $300 million this year, is that fiscal year 1987?

Mr. FUQUA. Fiscal year 1986.

Mr. LOWRY. Fiscal year 1986. So that would be a supplemental for 1986?

Mr. FUQUA. Yes.

Mr. LOWRY. To kind of stretch that out forward, again with the budget we're looking at, what would be an estimated cost for 1987 on a replacement program?

Mr. FUQUA. I think in 1987 the replacement orbiter goes up to something like—I'm informed it's around $700 million in 1987. It will take about 36 months to complete an orbiter. That would be the peak year, in fiscal year 1987, and then 1988 it would start coming down.

Mr. LOWRY. Thank you again, Mr. Chairman, for your excellent testimony. Mr. Frost.

Mr. FROST. No questions.

Mr. LOWRY. Thank you very much, Mr. Fuqua.

Mr. FUQUA. Thank you very much, Mr. Chairman.

Mr. LOWRY. Now I will call on Congressman Bob McEwen.

STATEMENT OF HON. BOB McEWEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. MCEWEN. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before you and the other distinguished members of the Budget Committee to express my support for the General Revenue Sharing Program.

As you know, local governments have always been forced to be more self-reliant and efficient in the delivery of services and forced to work harder, to be smarter, and do more with less. They are now being called upon to take even more responsibility, responsibility for the citizens that they serve, in addition to the fire protection, police, social services to the elderly, youth, poor, transportation, health care, rescue, parks, recreation, and so forth.

In the past they had help particularly from the most successful and innovative Federal program ever, the General Revenue Sharing Program. Conceived by Walter Heller and launched by President Nixon in 1972, it was based on a sensible premise, that Washington can raise revenue better and more equitably, but governments closer to home know better how to use it wisely. The new program was, "the demonstration of a principle that we have faith in people, we believe in people, and we believe that the government closest to the people should have the greatest support."

To a great extent, the dreams that many had for the Revenue Sharing Program have been fulfilled. Revenue sharing has been a

model Federal program. It has done what it was designed to do, to be the bedrock of a historic effort to reform the Federal system. It is the only program that goes practically to every local government in the country, many of which receive no other Federal assistance at all. It is the only source of Federal aid that remains virtually unencumbered by lengthy Federal restrictions and paperwork requirements. In fact, general revenue sharing funds are often used to pay for the unfunded mandates that come from other Federal programs.

However, if we accept the need to control Federal spending, this may well be the wrong program to eliminate, and in better budgetary circumstances, I would argue that this program be expanded, not eliminated.

I have long been a supporter of general revenue sharing and a strong advocate of its confidence in a local decisionmaking approach to federalism. But today, we are confronted with a budgetary crisis, and we must examine every program with the utmost scrutiny, must develop new solutions to new problems. The Federal Government can no longer afford to share revenues it does not have with communities like Beverly Hills, CA; Greenwich, CT; or Scarsdale, NY.

As the Federal Government reduces its overall role, however, it must assure that communities that face reduced Federal aid and growing service responsibilities, that the fiscal capacity to meet those growing needs can be met.

We must assure that general revenue sharing fulfills its fundamental role as a mechanism that mitigates fiscal disparities and does it in the most efficient manner possible. In short, I believe that a refashioned General Revenue Sharing Program is a fiscal safety net for needy communities.

As many of you are aware, Senator David Durenberger of Minnesota and I have introduced legislation calling for reauthorization and revision of the General Revenue Sharing Program to give it a stronger, more contemporary rationale. Let me briefly summarize some of the major components of this proposal, which is called targeted fiscal assistance or TFA.

This new program will serve as a safety net, albeit loose, for needy communities. This program will ensure that in our efforts to balance the budget, we do not ignore the very real and legitimate needs of our partners in the Federal system. TFA will provide general purpose grants to local governments, enabling mayors and local officials to determine the best uses for those funds. An interstate formula will determine each State's allocation, which, in turn, will be distributed to local governments through an intrastate formula.

By utilizing appropriate measures of need and fiscal capacity, the program will target funds to those communities with the greatest public burden.

In the intrastate formula, total taxable resources will be used as the measure of fiscal capacity. Total taxable resources is a comprehensive measure, devised by the Treasury Department, and it is the sum of economic resource of a State, all income received or produced in the State, and is more appropriate than per-capita income.

The effect of both the interstate and intrastate formulas included in the bill will be to direct the greatest proportion of a State's allocation to poor, rural, and urban communities, particularly those who have above average tax efforts relative to resources.

The question we face is, can we afford to continue this program. I believe we have no choice.

All of us are well aware that we are facing a challenging period. The decisions we face are not easy ones. This is true of all levels of government. The safety net program that we are proposing is the governmental counterpart to the social safety net.

We all accept that the Federal Government has a responsibility to provide a level of income security to individuals who are unable to provide for themselves. But it is also true that people are not randomly spread across the country. They are often clustered in our poorest States and cities. And just as the Nation has a responsibility to establish a minimum floor of support below which our poorest citizens will not be allowed to fall, I believe it has a similar responsibility to assist those governments which are hardest pressed to provide a minimal level of basic services.

Even in these difficult times, I believe this is a priority and purpose of the Federal Government.

Thirty years ago, President Eisenhower said, "Communities have the everlasting job of building a strong America and must have roots. America relies on the good sense and local knowledge of the community."

I say that our Nation must continue to rely on that good sense and provide, at the minimum, a helping hand to our Nation's mayors and local leaders, so that they may do the job which they have been entrusted.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McEwen follows:]

PREPARED STATEMENT OF HON. BOB MCEWEN

Thank you Mr. Chairman. I appreciate having the opportunity to appear before you and the other members of the Budget Committee to express my support for the continuation of the General Revenue Sharing Program.

Mr. Chairman, a multitude of pressing concerns confront our Nation's communities. Poverty; hunger and homelessness; increasing immigrant and refugee populations; drug use and drug-related as well as organized crime; a growing, elderly population, often on fixed incomes; and, a disenchanted youth population looking for skills, jobs and a future.

Add to that, plant closings and farm foreclosures have left permanent scars on our fellow americans in many industrial, manufacturing and agricultural based jurisdictions.

Many communities have been successful in marshalling the resources to cope with these problems and others have faced severe difficulties. Some cities have benefited from the more than 280,000 new jobs that are being created in America every month now for the past 42 months. However, some have lagged behind.

It has been our Nation's mayors who have launched innovative, efficient and cost-effective new programs to cope with the new realities of the eighties, showing Washington the way. However some remain in the quagmire of the past.

Mr. Chairman, We have entered a new era, and we are witnessing the most dramatic changes ever in the Federal Government's relationship between our Nation's cities. Domestic programs launched under the "Great Society" of the 1960's and taken for granted in the seventies have now come under close scrutiny, and the ever-sharpening knife of the new budget conscious converts in Washington.

Local governments have always been forced to be more self-reliant and efficient in the delivery of services—forced to work harder and smarter, and do more with less.

They are now being called upon to take even more responsibility for the citizens they serve in addition to the fire protection, police protection, socials services for the elderly, youth and poor; public transportation; health care; rescue services; and parks and recreation facilities and service, etc.

In the past, they had help, particularly from the most successful and innovative Federal aid program ever—general revenue sharing.

Conceived by a Democrat economist, Walter Heller, and launched by a Republican President, Richard Nixon, revenue sharing was the right program for 1972. It was based on a sensible premise: Washington can raise revenue better and more equitably, but governments closer to home know better how to use it wisely.

The new program was, as the President said at the bill signing ceremony in October of 1972 at Philadelphia's Constitution Hall "A demonstration of a principle that we have faith in people, we believe in people, and we believe that government closest to the people should have the greatest support."

He envisioned a program that would restore balance between the various levels of government. He said,

"After many years in which power has been flowing away from those levels of government which are closest to the people, power will now begin to flow back to the people again—a development which can have an enormous impact on their daily existence.

"In many states and localities, it will mean lower property taxes or lower sales taxes or lower income taxes than would otherwise have been the case. Revenue sharing can provide desperately needed tax relief for millions of Americans.

"In other places, revenue sharing will mean better schools or better hospitals.

"In some communities, this money will be used to put more policemen on the beat or to start new drug control programs.

"In still other instances, it will be devoted to job training or to recreational facilities or to public transportation.

"But the most important point is this: in each case it will be local officials responding to local conditions and local constituencies who will decide what should happen and not some distant bureaucrat in Washington, D.C."

To a great extent, the dreams that many had for the revenue sharing program have been fulfilled. Indeed, revenue sharing has been model Federal program. It has done what it was designed to do.

It has been the bedrock of an historic effort to reform the Federal system. It is the only program that goes to practically every local government in the country, including many of which receive no other form of Federal assistance.

Revenue sharing is the only source of Federal aid that remains virtually unencumbered by lengthy Federal restrictions and paperwork requirements. In fact, GRS funds are often used to pay for unfunded mandates imposed by other Federal programs.

Finally, GRS monies are distributed in a relatively targeted manner. Per capita revenue sharing payments range from almost $30 per person in our poorest communities to less than $5 per person in the our Nation's wealthiest jurisdictions.

However, if we accept the need to control Federal spending—which I do—this may well be the wrong program to eliminate. In better budgetary circumstances, I would argue that this program be expanded, not eliminated. I have been a long-time supporter of general revenue sharing and a strong advocate of its confidence in local decisionmaking approach to federalism.

But today we are confronting a budgetary crisis. We must examine every program with the utmost scrutiny. We must develop new solutions to new problems. The Federal Government no longer can afford to share revenues it does not have with communities like Beverly Hills, California, Greenwich, Connecticut, or Scarsdale, New York. As the Federal Government reduces its overall role, however, it must assure that communities that face reduced Federal aid and growing servicing responsibilities have the fiscal capacity to meet their growing needs. We must assure that general revenue sharing fulfills its fundamental role as a mechanism that mitigates fiscal disparities, and does it in the most efficient manner possible. We must, in short, refashion GRS as a fiscal safety net for needy communities.

Senator David Durenberger and I have introduced legislation calling for reauthorization and revision of general revenue sharing to give it a stronger, more contemporary rationale.

Let me briefly summarize the major components of our proposal which we're calling "Targeted Fiscal Assistance" or TFA.

This new program will serve as a safety net, albeit loose, for needy communities. This program will ensure that in our efforts to balance the budget, we do not ignore the very real and legitimate needs of our partners in the Federal system.

TFA will provide general purpose grants to local governments, enabling mayors and local officials to determine the best uses for the funds. An interstate formula will determine each state's allocation which, in turn, will be distributed to local governments through an intrastate formula. By utilizing appropriate measures of need and fiscal capacity, the program will target funds to those communities with the greatest needs.

AUTHORIZATION LEVEL

The program's authorization level will be $2.3 billion per year. While this represents a 50 percent reduction from the current revenue sharing, the targeted Fiscal Assistance Program will have a greater effect in reducing the resource disparities that exist among communities.

INTERSTATE FORMULA CHANGES

Under the interstate formula, low income, low revenue capacity States will receive a greater proportion of funds than high income, high capacity States. A single formula based on population, tax effort, and revenue raising capacity will determine the total allocation for all communities within a State. The population of the State will be adjusted by heavily weighting that portion of a State's population under 150 percent of the poverty level, thereby reflecting need. A relative tax effort formula is included to reward those States that attempt to meet their own needs.

In the interstate formula, total taxable resources will be used as a measure of fiscal capacity. Total taxable resources, a comprehensive measure devised by the Treasury Department, is the sum of all economic resources of a State—all income received or produced in the State. It is more appropriate than per capita income because it includes income received by the State's residents that was produced elsewhere (such as dividends from out of State sources or income of residents who work in other States). It also includes income produced in state by out-of-state firms and individuals (thereby including the States' ability to export its taxes, such as mineral severance taxes, etc.).

INTRASTATE FORMULA

The intrastate formula which distributes the State's allocation among the localities will target the funds to communities with the fewest resources but greatest needs, while restricting and, in some cases, even eliminating aid to jurisdictions that are well above the State average in per capital income. As in the interstate formula, tax effort is rewarded providing an incentive for jurisdictions to meet their own needs from their own resources.

The program will not have a floor on grants so that small "paper" governments, which provide virtually no services, will not. Can we afford this new program? I believe we have no choice.

All of us are well aware we face a challenging period. The decisions we face are not easy ones. This is true at all levels of government. The Safety Net Program we are proposing is the governmental counterpart of the social safety net. We all accept that the Federal Government has a responsibility to provide a level of income security to individuals who are unable to provide for themselves. But it is also true that people are not randomly spread across the country. They are often clustered in our poorest states and cities. Just as the Nation has a responsibility to establish a minimum floor of support below which our poorest citizens will not be allowed to fall, I believe it has a similar responsibility to assist those governments which are hardest pressed to provide a minimal level of basic public services.

Even in these difficult times, I believe this must be a priority of the Federal Government.

Thirty years ago, President Dwight D. Eisenhower said, "Communities are where the everlasting job of building a strong America must have its roots. America relies on the good sense and local knowledge of the community."

I say that our Nation must continue to rely on that "good sense" and provide at the minimum the helping hand to our local officials so that they may do the job with which they have been entrusted.

Thank you, Mr. Chairman.

Mr. LOWRY. Thank you, Congressman McEwen, for an excellent statement, and I'd like to say that I was sitting in this chair last year when you gave the statement on behalf of the 92 Group, which I thought was an excellent statement.

Mr. McEwen. Thank you very much, Mr. Chairman.

Mr. Lowry. What is the status of your legislation in the authorizing committee, or maybe some other alternative legislation, but what's happening on revenue sharing, the general options?

Mr. McEwen. As I understand it, it was necessary for some action to begin today in order to be—to qualify under the provisions of the Budget Control Act.

On Thursday, there was a noble attempt to pass my legislation, but in an effort to explain it, Representative Levin and others lost the quorum as members left town, and so they came back again today, and moments ago, as I understand it, reenacted an authorization in the subcommittee of the present program, subject to annual appropriations, with the understanding that that has lost a certain amount of support in the rationale of borrowing money to give to some units of government, which would then place it on deposit, and that there is significant sentiment in support of the provisions that Senator Durenberger and I have authored, and I believe that the full committee over the next couple of days will hopefully enact our revisions.

Mr. Lowry. That's the target—that's the targeting you're referring to?

Mr. McEwen. Exactly.

Mr. Lowry. Now is that in Government Ops?

Mr. McEwen. Yes, exactly.

Mr. Lowry. Thank you. Congressman Frost.

Mr. Frost. No questions.

Mr. Lowry. Thank you very much for your testimony.

Congressman Henry Nowak. Thank you, Congressman, for joining us. Please proceed.

STATEMENT OF HON. HENRY J. NOWAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK AND CHAIRMAN, SUBCOMMITTEE ON ECONOMIC DEVELOPMENT OF THE PUBLIC WORKS AND TRANSPORTATION COMMITTEE

Mr. Nowak. Mr. Chairman, members of the committee, I have a statement that I hope to summarize, submit for the record in total.

Mr. Lowry. Without objection, so ordered.

Mr. Nowak. I am here today, Mr. Chairman, once again to ask that you include in the budget resolution authority to fund the economic development programs. Mr. Howard, chairman of the full committee certainly concurs with my remarks before your committee.

The President's budget proposal for the sixth consecutive year calls for termination of the programs authorized by the Public Works and Economic Development Act, administered by the Economic Development Administration, and the Appalachian Regional Development Act which is carried out by the Appalachian Regional Commission.

The President has also recommended a rescission of funds already appropriated for these programs, as well as the deferral of $40 million of EDA funds, requesting only enough funds to phase out and monitor ongoing project activities.

We continue to strongly oppose the administration's efforts. Over the past several years we have talked about the findings of the committee's 1981 and 1982 evaluation of these programs.

Those findings bear repeating because they clearly show that the seed money investments by the Federal Government in communities and businesses with great potential, but located outside the economic mainstream have produced returns in terms of jobs created and retained, and tax revenues that have really contributed to our national economic recovery.

For EDA, the Federal investments of about $5 billion have leveraged $9 billion in private capital, generating 1.4 million private sector jobs, and returns of $6.5 billion annually to Federal, State, and local treasuries.

As for the Appalachian Regional Commission, testimony shows that more than 1.5 million jobs have been created. And the overall well-being and future outlook of the region's citizens have been enhanced by by the development of highways, and the access roads constructed, and by the nonhighway projects that have improved health and education levels and provided vocational training, housing, and really basic water and sewer systems.

I have, in my testimony, gone through a litany of successes. And certainly they outweigh, Mr. Chairman, all of the failures that have been repeated by this administration. I think based on its 20-year record, EDA has the experience and can provide the expertise to assit State and local development activity to address the economic adjustment that must take place to remain competitive in the world marketplace.

Even with reduced resources, EDA remains an irreplaceable national resource for planning and research. Perhaps more importantly, for seed money to stimulate local, State projects, and as a disseminator of information on the latest experiments and successes in economic development.

These programs continue today, in large part, because you and other members have been sufficiently concerned about the economically distressed areas of the country to retain economic development assistance programs in the face of administration efforts to eliminate them.

Mr. Chairman, I hope that you and your committee will continue to see the value of these important investment programs in providing assistance to some of our Nation's poorest communities, that have potential, and that with Federal help, can pull themselves together and achieve what was previously considered impossible.

I certainly would urge and request that you keep the EDA programs ongoing, and permit the orderly completion of the Appalachian Governors finish up activities.

[Testimony resumes on p. 746.]

[The prepared statement of Mr. Nowak follows:]

PREPARED STATEMENT OF HON. HENRY J. NOWAK

Mr. Chairman, Members of the Committee, I am here today to ask, once again, that you include in the budget resolution authority to fund the economic development programs. Mr. Howard, Chairman of our full Committee, concurs with my remarks before your Committee.

The President's budget proposal, for the 6th consecutive year, calls for termination of the programs authorized by the Public Works and Economic Development Act administered by the Economic Development Administration, and the programs authorized by the Appalachian Regional Development Act and carried out by the Appalachian Regional Commission. The President also has recommended rescission of funds already appropriated for these programs, as well as deferral of $40 million of EDA funds, requesting only enough to phase out and monitor ongoing project activities.

We continue to strongly oppose the Administration's efforts, despite the urgency of reducing the budget deficit.

Over the past several years, we have talked about the findings of the Committee's 1981 and 1982 evaluation of these programs. Those findings bear repeating because they clearly show that these seed money investments by the Federal government in communities and businesses with great potential, but located outside the economic mainstream, have produced

returns in terms of jobs created and retained, and tax revenues that have contributed to the national economic recovery.

For EDA, the Federal investments of about $5 billion leveraged $9 billion in private capital, generated 1.4 million private sector jobs, and returns $6.5 billion annually to Federal, State and local treasuries. Recent testimony presented at Committee hearings since that evaluation continues to reflect gains as a direct result of EDA efforts. For example, in Arkansas for the period 1965 to 1985, $165.3 million EDA dollars invested resulted in a total 447 projects that created 79,630 jobs, generated an annual payroll of $645.5 million and annual taxes paid of about $129.1 million. In Baltimore, an $11.3 million EDA Title IX grant and city funds invested in the Holabird Industrial Park, resulted in private investment of more than $300 million, retained some 4000 General Motors jobs, created 1000 jobs as of a year ago, with at least 2,500 jobs expected to be created.

EDA successful investments have far outweighed the failures.

As for the Appalachian Regional Commission, testimony shows that more than 1.5 million jobs were created. The overall well-being and future outlook of the Region's citizens has been enhanced by the development highways and access roads constructed and by nonhighway projects that have improved health and educational levels, provided vocational training, housing, and water and sewer systems. The

finish-up program proposed by the Appalachian Governors at the request of Congress in 1982 is designed to complete essential segments of the highway system, stimulate regional private investment and entrepreneurial activity, job retention and creation, and provide basic services for the Region's poorest counties.

If I seem to overuse the word "investments", I do so in order to emphasize that the Federal money expended through these programs has been used to provide financial returns and future benefits and advantages to the areas directly involved, as well as to the Nation. They are not financial burdens to the taxpayers, serving no national purpose, as has been portrayed by Administration officials.

The Committee acknowledges the merit of and need for Administration policies aimed at providing non-inflationary growth and restoring the country's competitive position in world markets. However, in our years of experience with regional and local economies, we have clearly seen that policies designed solely to improve national economic expansion have bypassed some areas. Efforts which, at the national level, are essential to stimulate innovation and creation of wealth, too often are insufficient in allocating economic resources and distributing economic opportunity. We are a Nation of regions, each with different resources. We are interdependent parts, with each part having a cumulative effect on the overall national economy. The Nation

cannot afford to turn its back on any part or to waste any of these resources, human, economic or natural.

The commitment of every Member of the Public Works Committee to reduce our national deficit is very real and strong. At the same time, we firmly believe there is a continuing urgency for retaining our targeted economic development programs at current levels.

In recent years, as Federal dollars have been reduced, we have seen increased activity at regional, State and local levels and in the private sector to work together in developing strategies to enhance economic development. This is good, and State and local governments should bear much of the responsibility for designing and carrying out development strategies.

However, there is a continued need for a Federal development role as a catalyst and supporter of efforts at regional and subregional levels to help bring chronically distressed areas into the mainstream. In addition, it is important to retain the Economic Development Administration programs so that, in times of national economic necessity, an efficient mechanism, dedicated solely to economic development, will be in place, needing only an infusion of additional funds.

Members of the House have consistently demonstrated strong bipartisan support for a continued Federal presence in economic development. Last September, H.R. 10, which would

improve and refocus the existing programs to address economic needs of the 1980's, passed the House by a vote of 260 to 96. In the 98th Congress, the same bill passed by a vote of 306 to 113; and in the 97th Congress, similar legislation passed 281 to 95. In addition, last July, when an amendment to strike all funds for the Economic Development Administration was made during House debate on the appropriations bill, it was soundly defeated by a vote of 315 to 98. A similar effort in the Senate was also defeated.

Although legislative changes have not been made since the authorizations ran out in 1982, our committee continues to monitor the agency's implementation of funds appropriated to carry out existing economic development programs.

In addition, the committee is keenly aware of changes in economic development strategies taking place at the state and local levels as a result of the devastating impact of imports on our older industries. Because of heavy foreign competition, they are losing product market share annually.

There is a widening gap between U.S. imports and exports which has cost an estimated 2 million jobs since 1980. Recently the Commerce Department reported that the American merchandise-trade deficit was the worst ever in 1985, reaching $148.5 billion, up from $123 billion in 1984. More than ever, EDA is needed to help address the economic adjustment that must take place to remain competitive in the market place.

Based on its 20-year record, EDA has the experience and the expertise to encourage this trend of state and local economic development activity. Even with reduced resources, EDA remains an irreplaceable national resource for planning and research, for seed money to stimulate local-state projects and as a disseminator of information on the latest experiments and successes in economic development.

These programs continue today in large part because you and other Members have been sufficiently concerned about the economically distressed areas of the country to retain economic development assistance programs in the face of Administration efforts to eliminate them.

Mr. Chairman, I hope that you and your Committee will continue to see the value of these important investment programs in providing assistance to some of our Nation's poorest communities that have potential and that, with Federal help, can pull themselves together and achieve what was previously considered impossible.

I urgently request that you keep the EDA programs going and permit the orderly completion of the Appalachian Governors finish-up activities.

Mr. LOWRY. Thank you, Mr. Chairman, for an excellent statement. As you know better than I, EDA and the Appalachian Regional Commission has had strong bipartisan support in the House. Your H.R. 10 passed overwhelmingly. What is the situation in the Senate?

Mr. NOWAK. Well, the Senate has still not been able to provide us anything to go to conference with. We passed, as you know, in three Congresses now overwhelmingly—almost 3 to 1—the legislation which would really improve the existing programs, and give us a way to provide economic development assistance to meet the future, needs of the 1980's and the 1990's.

We hope that the Senate will move, so we can at least get into a debate about the best methods to improve the existing ongoing programs.

But in the meantime, there is a lot of activity that I think can be carried on by this administration, in looking at the kinds of fiscal and trade policies that have impacted communities all over the country without their ability to do anything about. They are not forewarned, they are just impacted.

And then, of course, there is no other program out there, when you look at the kinds of budgets that we receive from this administration. All of the economic development activities that were carried on are targeted for elimination. And I think EDA could have even a bigger role to play to try to make some impact where we have severely hard hit local communities, and large basic industries, because of Federal trade and Federal fiscal policies.

Mr. LOWRY. Thank you. Yes, back in the days of the Boeing depression and the signs said, the last person out of Seattle, turn off the lights, had we not had EDA and some things at that time—I know there are other communities experiencing those things now.

The gentleman from Texas.

Mr. FROST. No questions.

Mr. LOWRY. The gentleman from Florida.

Mr. MACKAY. No questions.

Mr. LOWRY. Thank you very much, Mr. Nowak.

Mr. NOWAK. Thank you very much, Mr. Chairman.

Mr. LOWRY. Congresswoman Patricia Schroeder. We are honored to have you here.

STATEMENT OF HON. PATRICIA SCHROEDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Ms. SCHROEDER. I am delighted to be here, Mr. Chairman, and I thank you for your staying power.

Mr. Chairman, and members of the committee, I would ask unanimous consent to put my statement in the record—because I have always been, what you would call a text deviate. So, if I could do that, it would probably be more grammatical than I tend to be.

I am here to talk about the defense budget. And I think, if you look at the President's budget, it is clearly out of balance. We know that there is a bipartisan agreement that the numbers are probably wrong and the deficit is much bigger and all of that. But when I talk about out of balance, I am talking about the priorities in that budget.

I think if you gave the President his way, what you would be doing is increasing defense in real dollars since 1980 by almost 50 percent. And in the interim, you know what he is doing to domestic programs on the other side. I have been sitting here listening to the prior testimony. You have been doing it longer than I have. So that is being slashed way, way down on the other side.

I think we all know that national defense is a composite of a whole lot of things. It is not just what new glitzy item you are buying this year. Education, all those things are very, very important.

So, I think it is really out of balance when you look at what he is doing. There is no question we have to look at both the threat and the debt, to quote the chairman of this committee. The threat and the debt are both on the table.

Now first of all, we think the President's debt is wrong. But I think the way he looks at the threat is really wrong too. When you look at what we have been doing for the last 5 years, it is almost buying anything that you want to buy. It is like an exercise in making certain people's dreams come true.

I have gone through it in my testimony and said, you know, you have got the General Patton fantasy which we have been doing. At the same time we have been doing the Admiral Nelson fantasy, and we have also been doing the Captain Kirk fantasy. We are fighting everywhere. We are buying everything at any price. They cannot price it high enough, we will still buy it.

In the interim, I think we have really harmed people. And my feeling is, we should go back to the John Kennedy type of approach, not only ask what you can do for your country, but—do not ask what you can do for your country—ask what you can do for it, not what it can do for you.

The people who have done a lot for this country, the people who are in the active duty military have had a real tough row. Last year we passed for the second time the GI bill. That, to me, is the least we can do for people who are in the military. To think that they can save enough for their education is a joke. We are kidding ourselves.

And what did he do? He zeroed it out. It is not there. We did an awful lot for family programs. We fought hard to get that five-sided building to have five slots in the Secretary of Defense's office that dealt with families. You know what? They are going to give us three, out of the tens of thousands of people that are over there.

Well, once again, we all know what families in the military go through. For every dollar they are reimbursed for moving, they are adding 3 more out of their pocket. The housing programs, the day care programs, and on and on and on, the spouse employment programs. We have dealt with that over and over—gone.

We know what has happened to many of the veterans programs. I mean, if we do not have a contract with the people who have done the most for their country; that is, disabled veterans, and we see them being cut, we really have lost what it is all about.

So, my hope to this committee is that when you look at this debt versus threat, you take some of these fantasies and try and get them down into reality. What is the reality of the threat, rather than to just let everybody have their fantasy and put it in.

You also deal with, I think, the most important part of the defense, which is morale and how you treat the people that are there. Because if we continue mistreating them in the way we are doing, if we adopt the President's program, good luck the next time we need them. If you see disabled veterans being in trouble, if you see the current people losing GI benefits, you know, when you go to get the next group they are going to say, "Hey, we are not dummies."

And not only that, the new measuring rod has been, "Hey, are you better off?" Well, you are not going to be any better off if this stuff happens, so why in the world would you enlist, why in the world would you volunteer? I think that is important.

We have to also realize that one-third of our defense budget goes to maintain 250,000 soldiers in Europe. Eisenhower was right, they have rebuilt, guess what, you know. I mean, and if I were a European I would say, terrific, keep them all over here. It saves us money. They have more money for social programs, housing, and everything that we do not have. Well, it is about time that they start doing more.

The same with the Japanese. I know they cannot raise an army. I understand that. It is in their—but it does not say they cannot pay. We should spend fortunes? It is $20 billion for a carrier task force to put out there to keep the oceans open so they can send Subarus over for the national ski team.

Now, you know, at some point why do they not help pay to keep the oceans open? They could pay for that. And it would help us be more competitive. We have just put in all those new bases at Massawa where we are paying for everything again. And you know, I mean, at some point we look like Uncle Sugar, Uncle Stupid.

You know, that is fine if the cornucopia keeps flowing out with money. It does not because the debt is on the table, too. And I think finally, you know, you are hurting our own people who have made a commitment to this Government, who have given up the prime of their life when they are young to serve, and many have been injured in that service.

I mean, to cut them out of educational benefits and other, it is absolutely shocking. So, it out of balance how you treat domestic versus military, and it is out of balance internally in the military when you look at personnel versus all these fancy fat-cat groups that are selling us all this junk.

We know about the toilet seats. We know about all of that. I look at the President's program. There are 64 proposals in the President's program for cutting money. Not one deals with military procurement.

I chaired the Grace Commission panel for the Armed Services Committee. Every time you put a microphone in front of the President he talks about J. Peter Grace. Mr. Grace appeared in front of our panel and said, in all candor—and I am sure it pained him to say this—that the agency who had followed his recommendations the least, and had given him the coldest shoulder, and was the fastest turnoff was—this is going to be a surprise—DOD, the Defense Department.

Well, it is very clear. To quote David Stockman, "The hogs keep right on feeding." If this thing goes in, I think it is wrong, and I think that it is time that we really take that into effect.

Now Congressman Ron Dellums and I have been doing alternative defense budgets. We will be doing it again. It will be coming out very shortly. Instead of $320 billion, we are looking at a range of $240 to $260 billion. We are obviously leaning in favor of people programs. I mean, our people in uniform, not their people in three-piece suits that are making, you know, six figures a year.

I will grant you, the President has much more compassion for them than we do. We feel the people you take care of in this budget are the people whose lives are on the line, not to some stockholders, but to taxpayers, and protecting this country and keeping it strong.

So, ours is going in that way. We will get it over here. We certainly hope you look at it. I think that we have got to have a budget that is 50–50. That if defense does not bear its half, I do not think it is going to pass.

So, when we put it together, it has got to be 50–50, hopefully remaining true to the people who have been true to us and really served this country well, and we keep that perspective.

And I thank you very much for allowing me to appear this late in the afternoon.

[The prepared statement of Ms. Schroeder follows:]

PREPARED STATEMENT OF HON. PAT SCHROEDER

Chairman Gray and members of the committee, thank you for inviting me here to testify today. The President has presented us with a budget seriously out of balance. I am not talking about the deficit, which OMB claims will be $144 billion but which Chairman Gray and others have shown to be far higher. Congress has strongly stated its intent to end deficit spending but the President is back up to his old tricks.

I am talking about priorities. If the President were to get his way for fiscal year 1987, defense would have gone up 49 percent in real dollars since 1980, while education and training would have gone down 39 percent, community development down 59 percent and commerce and housing down 89 percent over the same period.

Do we really believe in slashing education and all but abandoning our cities to pay for more $600 coffee pots, artillery guns which can only destroy out-houses in test firings, and space lasers which will probably never be able to effectively block a missile attack?

The President says we cannot deal with defense in the same terms as we deal with domestic programs, that the budget for defense is "the price for peace." I wish that were true. I'm afraid that much of the defense budget is the price for greed.

But even if you are able to ignore the rampant waste in the Pentagon, as apparently Secretary Weinberger is, the defense budget seems to be an exercise in making dreams come true. Let me describe some of the fantasies:

The General Patton Fantasy: The Russians invade Western Europe using their 29,000 tanks. Somehow they are able to get around the Mercedes and BMWs on the autobahns. We rally, deploy our artillery and fight them just like we fought the Germans in 1944.

The Admiral Nelson Fantasy: The Russians decide to engage us in naval warfare. They come to attack one of our carrier battle groups, hoping to knock out the carrier. But we fool them. Our AEGIS cruisers track their incoming activities and we engage them. In a great naval battle, we sink the Russian fleet.

The Captain Kirk Fantasy: The Russians launch their ICBMs. Our supercomputers determine there has been a launch and focus our lasers and particle beam weapons and railguns on the Soviet warheads. Due to great technology, we destroy all the Soviet missiles.

It is for these and similar fantasies that we have been spending $300 billion a year. We spend one-third of our defense budget to maintain a quarter of a million

soldiers in Europe. This relieves our NATO allies of the obligation to defend themselves. We spend $20 billion a crack to buy carrier battle groups. We never calculate the long term costs of manning and maintaining these drifting dinosaurs. And the President wants to spend $5 billion this year for SDI. This despite the fact that the technologies for missile destruction and the software for tracking and interception now appear ineffective to do the job.

Yet, recent experience, logic, and fiscal prudence tells us we ought to be preparing for rapid mobilization to contain regional conflicts. We ought to be flexible, deployable, and ready to fight. And, we should have a plan to expand our forces rapidly for a larger fight.

Rep. Ron Dellums and I have put together an alternative defense budget to produce the type of military we need. We can fully fund this military at substantially less cost than the $320 billion the President requests. Frankly, I believe budget authority in the $240 to $260 billion range is quite adequate.

At this time of excruciating deficit cutting pain, this Committee must lead the way in refocusing our defense budget to deal with the world as it is, not as some Pentagon dreamers wish it were.

Mr. LOWRY. Thank you very much, Ms. Schroeder. And I know that I speak for just about everybody in the House when I say we appreciate the job that you do for our military personnel.

Ms. SCHROEDER. Well, thank you.

Mr. LOWRY. I mean, and every time the Joint Chiefs of Staff comes in before this committee—of course, you see them all the time before your Armed Services Committee—they always say, our most important thing is personnel. And then they present us a budget that cuts the heck out of personnel and puts it all into exotic weapons systems.

Ms. SCHROEDER. Absolutely.

Mr. LOWRY. Too much. Not all, but quite a bit.

Ms. SCHROEDER. Can you believe three slots for the family? I mean, that is unbelievable.

Mr. LOWRY. Thank you very much for your——

Ms. SCHROEDER. Thank you.

Mr. LOWRY. Congressman Frost.

Mr. FROST. Just a brief question. Ms. Schroeder, when you say 50-50 defense and domestic—the CBO baseline includes a budget authority freeze in defense this time—are you saying that we should cut below a budget authority freeze?

Ms. SCHROEDER. That is right. I do not think you have any alternative. And I think what we may have to do as a Congress is say, this is what we have to do because of the playing field that we are on, to get a budget out of here.

And then maybe we should look at the threat—I mean, that is because of the debt—and then we should look at the threat, if we do not think that is adequate and say, maybe this is what we should do if the President were willing and reasonable and ready to talk about some kind of revenue. But throw it at him.

Mr. FROST. All right. But in terms of what realistically has a chance of passing the House, are you suggesting that we go to an outlay freeze? Are you suggesting that we go below an outlay freeze? Now I am not talking about what in the—if you had your druthers if you could write the budget yourself. I am talking about realistically in terms of what we could put together that would have a chance of passing.

Ms. SCHROEDER. Whichever you pick, you know—and I do not want to try and second guess the Budget Committee—whichever way it goes, I think there is no way in the world you are going to

get any budget that passes in this House that does not hit equally on both sides of the line, whether you do outlay freeze or whether you do, you know, anything that you want budget authority or whatever. As long as it is not—does not look equal, 50–50, we are in trouble.

And I think that is what Gramm-Rudman said. I mean, Gramm-Rudman said 50–50. I did not vote for Gramm-Rudman, but I think you had a consensus of the House on that. So, I think that the President's budget is just totally missing the mark. I mean, he signed Gramm-Rudman, it said 50–50, and he shows up with this thing that is not 50–50 at all.

Mr. FROST. Of course, he had his fingers crossed behind his back on the question of defense. We all understand that.

Ms. SCHROEDER. We understand that. But I hope the American people understand that. That this is a real game. And I just do not see anybody, after having watched this terrific buildup for the last 5 years in the House being ready to accept anything less than at least a 50–50. A lot of us think that defense could be cut even more than that. But anything beyond that will never get past this House.

Mr. FROST. Thank you, Mr. Chairman.

Mr. LOWRY. The gentleman from Florida.

Mr. MACKAY. No questions.

Ms. SCHROEDER. Thank you very much.

Mr. LOWRY. Chairman Fascell, Congressman Mica—and I do not believe Congressman Broomfield is here.

Thank you very much, Mr. Chairman, and Mr. Chairman of the subcommittee, for joining us.

STATEMENT OF HON. DANTE B. FASCELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA AND CHAIRMAN, FOREIGN AFFAIRS COMMITTEE

Mr. FASCELL. Thank you very much, Mr. Chairman, members of the committee. Chairman Mica, who is chairman of the International Operations Subcommittee, and has a separate bill of authorization on other matters, is also here from the Foreign Affairs Committee. I would like to say that one, we don't envy your job, any of you who are members of this committee, in dealing with the deficit and the allocations within the budget. That is always extremely difficult.

Two, the judgments with respect to priorities and allocations within the budget, now that we have finally gotten the administration to agree on a cap on the deficit for fiscal 1987, no mean feat, I might add, gives us the same responsibility and we are obviously going to have the same struggles of reallocation within the budget to achieve the kind of things that the gentlewoman from Colorado was talking about.

It is very difficult to achieve that kind of balance and yet we must do it. I agree with the general thrust of the testimony which has been presented to this committee. There is no doubt in my mind that the budget as presented by the executive branch is out of balance with the needs of the people of this country. It is very hard to justify to anybody that the needs of this country are so

great that you have to stop hot meals to senior citizens who cannot afford to have a hot meal and who can only exist because of it.

I do not want to go through the litany of all of the programs which I believe, in health, education and other matters in this great country of ours, deserve a priority within the budget. Therefore, I think it is incumbent upon the Budget Committee to restructure the budget, as you have done in the past. I congratulate you for what you already have done in this respect.

The job in the fiscal year 1987 budget may be even tougher. It is because of that that the Committee on Foreign Affairs took a look at the request that came to us to see what could be done in order to deal with the problem which all of us know has to be faced, and which is the direct responsibility in the first instance of the Budget Committee.

The Executive request, if I may refresh your memory, came to us for fiscal year 1987 $2.5 billion above what it was in 1986. While all of the executive branch requests, one way or another, can obviously be justified, the truth of the matter is we all realized that tough decisions had to be made. We were looking for ways to come to this committee with some running room out of the 150 account, so that you could perhaps have a little bit of flexibility in dealing with some of the other domestic matters which are so important to the people of this country.

We did that. We reached an agreement in a bipartisan sense. I want to express my appreciation to the minority ranking member, Mr. Broomfield, who is unfortunately not here and to all of the minority members of the Committee on Foreign Affairs. We have made a very strong effort in our committee to achieve bipartisan action both as a matter of foreign policy and as a way of approaching this budget.

We come to you on that basis. Basically what we have done is take the current baseline, which is the fiscal year 1986 appropriation with the postsequestration cut, and recommended an 11-percent cut from our existing authorization, because we had already passed a 2-year authorization. This represents what we come to you with, 11 percent below our authorization, and 14 percent below the administration's request.

When you apply that to actual outlays for fiscal 1987, you come down to 16 percent. That is basically what it is.

To sum it up, the current baseline after the 4.3-percent cut is $15,476,497,000. Our recommendation would be for $15 billion flat. In outlays, our recommendation is $14,106,315,000, Mr. Chairman, which is $1 billion below current outlays.

What we are saying is that we have bitten the bullet. I would hope that other committees would have the opportunity to do the same thing. I believe it would be helpful in dealing with the responsibility you have, if you had some guidelines from all the committees.

I will confess that the temptation was very great just to put this all behind us and to come in here and say, look, this is what the administration has requested and we have already passed an authorization bill which basically straight lined the year before. I want to emphasize that, Mr. Chairman. When we passed our au-

thorization bill we did not do an inflationary factor in the 1987 authorization bill. We took it right off the 1986 authorization.

We are below that in this recommendation. This represents a good faith effort on our part. We know it will be accepted that way. We would like to say that we hope that because we have acted in a responsible manner now, that we are not going to get caught up in the rush that will always engulf this committee in the necessity of making changes on a dollar-for-dollar basis in order to get where you want to go.

I can't give you an exact estimate, but I think if every other committee came in reasonably close to this, we could reach the cap on the deficit that you are struggling with.

I have to add one thing. What I have talked about so far are Executive requests that came in on time. We have requests which did not and must be considered as supplemental to this. One of those is the Inman supplemental. Since my colleague here, the gentleman from Florida, is the chairman of the subcommittee of jurisdiction and served on the Inman panel, and has been a leader in the fight on our committee on this whole question of terrorism and how we enhance our capability with respect to that, I would like for him to just take a moment or two to explain that program to you and give you the numbers on it.

[The prepared statement of Mr. Fascell follows:]

PREPARED STATEMENT OF HON. DANTE B. FASCELL

Mr. Chairman and distinguished Members of the Committee on the Budget, I appreciate this opportunity to discuss the recommendations of the Committee on Foreign Affairs with respect to the President's fiscal year 1987 budget request.

At the outset, I would like to commend you, Mr. Chairman, for making today available to Standing Committees to report on their recommendations. This hearing is a useful element of the consultation process mandated by the Gramm-Rudman Balanced Budget and Deficit Reduction Act.

Last Thursday, the Committee on Foreign Affairs in unanimous bipartisan agreement approved the report which is now before you. We believe the report represents a proper balance between meeting the requirements of national security and foreign policy interests and the Gramm-Rudman targets for deficit reduction in fiscal year 1987.

Specifically, we recommend a budget authority and outlay floor of $15 billion and $14,106 billion respectively for ongoing discretionary programs and activities in the international affairs budget function under the sole jurisdiction of the Committee on Foreign Affairs. These levels represent a cut of $476 million in budget authority and a $1 billion reduction in outlays from the post-sequestration levels for fiscal year 1986. Compared to the fiscal year 1987 Executive request, the Committee's recommendations are 14 percent lower than the request for budget authority and 16 percent lower than the request for outlays.

These amounts are exclusive of the President's fiscal year 1987 request of $1.4 billion in budget authority and $629 million in outlays for improving embassy security abroad (the "Inman Package"). This crucial initiative is strongly supported by the Committee and the House leadership, which has scheduled the required authorization as part of an omnibus anti-terrorism bill for floor action the week of March 17. The Honorable Dan Mica, Chairman of the Subcommittee on International Operations, is here with me to answer any questions you may have on this initiative. I would note that even with the addition of the Inman money, the Committee's recommendations are still $500 million below the post-sequestration fiscal year 1986 outlay levels, and $2.8 billion below the President's fiscal year 1987 outlay request.

These recommendations include all budget accounts in the 150 function except the international financial institutions, the International Trade Commission, the Foreign Claims Settlement Commission, Food for Peace, and the Export-Import Bank.

Mr. Chairman, I believe that my Committee has taken a virtually unprecedented step by recommending to you cuts in our programs which are below the President's request, below the 1986 post-sequestration baseline, and below the authorizations we

have already enacted into law for fiscal year 1987. Without the support of our minority colleagues, we could never have achieved this recommendation. I would now urge you not to penalize us for doing the responsible thing, by cutting these levels even further. We made our cuts in good faith, even though it was painful; they do not allow any "fat" or room for further cuts which would cripple our ability to protect our national security interests. I will not take the time to discuss the impact of any further cuts, since they are outlined in the Committee's report, but I would be happy to answer any questions you may have.

Mr. LOWRY. Congressman Fascell and Congressman Mica, we are delighted and we really appreciate the job that you do.

STATEMENT OF HON. DANIEL A. MICA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA, AND CHAIRMAN, SUBCOMMITTEE ON INTERNATIONAL OPERATION OF THE FOREIGN AFFAIRS COMMITTEE

Mr. MICA. Mr. Chairman, let me just say it is my pleasure to be here before your committee also. I thank you very much. I have to second my chairman's comments on the difficulty of the job that faces you. I must say I, too, have looked at the President's budget.

Even as one who supported some of the President's actions, I cannot support this budget, to transfer money essentially out of domestic programs into defense and the way it has been done in this particular budget just does not warrant my support nor that hopefully of the committee or the Congress.

Aside from that, let me summarize this. As Chairman Fascell has just indicated, the figure of $14.1 billion in outlays for 1987, that is substantially below the 1986 figure. With the Inman package, the antiterrorism embassy security package, as an add-on on top of that as a supplemental, we would be talking about an additional outlay of $500 million in 1987, bringing it to $14.6 billion. That still would be below the straight line figure of 1986.

Let me just give you a quick 2 minute history of the Inman Commission and the recommendations. After the bombing in Beirut, there was an outcry in the Congress and nationwide that we need to do something to make sure our embassies and our personnel overseas are protected. A panel was appointed, one Member from the House, being myself, and one from the Senate, three private citizens headed up by Adm. Bobby Inman.

The approach was to see what we need to secure as reasonable men and women can do, to secure our embassies and facilities overseas. The original request came in at about $5.6 billion over a 5-year period. When that request was submitted to the administration and OMB, it was trimmed down to $4.4 billion. This is a 5-year program. It sets minimum standards, one very expensive standard, for instance, is a major set back for every embassy. Incidentally, this Congress and this committee is sitting on a list of about 120 embassies worldwide that are considered major security threats and need enhancements.

There are setback requirements, barrier requirements, electronic penetration prevention and so on, that we set out as basic requirements, if we are going to have embassies overseas and we are going to have personnel.

Frankly, it stalled before the administration for some 6 months. I and my committee prodded them and said, either give us the package so that we, the Congress, can do something with it or we will

start bringing home personnel overseas. The last day of the Congress last year, the package was presented. Speaker O'Neill has since noted that package has been here in the Congress for a little over a month now, coincidentally, I might say, during the break, so it would have been before the Congress if there had been a problem overseas which we were concerned about.

Nonetheless, last Friday, the Speaker called us together, all of us involved with terrorism and said, this package has to move before the House as quickly as possible, it must be done in a cost-saving manner, we are looking to cut that figure somewhat if we can, but he wants it up before the Easter recess. I think from every hearing we have had from last fall until this week, we have not had a single witness say that we don't need to move forward with this. It has been totally bipartisan. It has been virtual total support.

The only questions we have is we are still refining our dollar figures on specific facilities and so on and we are hurrying it as much as we can. We think we need as a Congress and as a committee to move this legislation before we have another international terrorism incident.

The bottom line, we think a minimum amount of $500 million in this year's budget as a supplemental, on top of the chairman's request, this could not have been put in there, in the earlier version. It was not even before the Congress. We think we are going to have to move very quickly.

The Speaker has said that he hopes to have an omnibus terrorism bill covering domestic terrorism, international terrorism, but regardless of whether that package is ready or not, he wants to schedule this bill on the floor within 3 weeks. That is where we are.

Mr. FASCELL. We will go forward, Mr. Chairman, with the full authorization of the Executive request. That will include authority for the Appropriations Committee to outlay whatever it wants to outlay for fiscal year 1986. That is not before you. In fiscal year 1987, we are talking outlays of $500 million.

I want to conclude the statement of my colleague by saying that this initiative of security enhancement overseas and protection of personnel has been an initiative of the Foreign Affairs Committee for many years. We laid out a program and provided the authority, and the Appropriations Committee provided the money. What happened along the line was it slipped, was deferred, stretched, pulled and otherwise not acted upon because of the struggle within OMB and in this administration.

It was only after the debacle in Lebanon that the administration rushed up with a $340 million program to catch up on a program that should have been almost 75 percent complete by that time and was not. This worldwide review is a different matter. You have enhanced technology involved in all of this, and it is a program which, in my judgment, has to go forward. It is of the highest priority.

One other thing, Mr. Chairman. We have not yet been sent a package on economic assistance pursuant to the Anglo-Irish Accords. We understand that it will represent an outlay of $50 million a year for 5 years. I don't know how we are going to handle that, but it will be up here and it is something that the committee

will have to take into consideration. I am in enough trouble now without giving you any more leads about what to do.

In all fairness, Mr. Chairman, what we have been talking about, as far as we know, cleans the deck. That is all of it. I don't know of any loose ends around anywhere. This is all of the 150 function accounts that we are responsible for. It does not include international financial institutions, the International Trade Commission, Foreign Claims Settlement Commission, Food for Peace, Public Law 480, and the Export-Import Bank. I understand that in that, there is a $300 million mixed credit program.

I have no vision of that at all right now except to say that every minute that we have worked on this budget, and it was a long time, we began to have a fuller appreciation of what you members on the Budget Committee have to go through in order to come out with a package that is balanced internally among accounts, provides for the national welfare and domestic needs as well as for the security of the country.

We hope that what we have done here helps you in that respect and, to the best of your ability, will not punish us any further since we are $2.5 billion below the President's request.

Mr. LOWRY. Only a fool would fool with Dante Fascell. An excellent report, Mr. Chairman. If you would convey our thanks also to your esteemed ranking minority member, Mr. Broomfield, who I know is tied up in another meeting, and thank you for the report and the leadership of both you gentlemen on the Inman panel, a very vital thing. You did a real job on this. Thank you.

Mr. FASCELL. Thank you very much.

Mr. LOWRY. Congressman Jaime Fuster. Thank you very much for joining us, if you would just proceed.

STATEMENT OF HON. JAIME B. FUSTER, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF PUERTO RICO

Mr. FUSTER. Mr. Chairman and distinguished members of the Budget Committee, I appear before you on behalf of the 3.5 million American citizens who live in Puerto Rico who I represent in the U.S. Congress.

Because of the time constraints set by the committee, I will limit my testimony to the very basic issues and concerns of my constituents regarding the Federal budget—issues and concerns that I will briefly highlight.

Before I begin such task, however, let me also very briefly review for you some relevant facts about the people I represent in Congress.

After an 88 year long legal relationship between the island and the mainland and despite substantial economic development, particularly during the 1950's and the 1960's, Puerto Ricans still remain the poorest group within the American population.

Per capita personal income is far below mainland levels, amounting to one-third of the level for the United States generally and to half the level of the poorest of the 50 States. Mean family income for all the families in Puerto Rico is only slightly above the U.S. poverty level. Unemployment in Puerto Rico has remained over 15 percent since 1975 and has been over 20 percent since 1982, recent-

ly going up as high as 24 percent. Close to half of the population of the island is currently participating in the federally funded Food Nutrition Program. Approximately half of the families participating in that program in 1984 had a total income of $2,000 or less.

Economic growth since the early 1970's has been nearly null and net out migration from Puerto Rico to the mainland has been growing steadily since the last decade and a half.

In spite of the very dire economic circumstances of the island, Puerto Rico does not participate at all in several major Federal assistance programs, such as General Revenue Sharing and the Supplemental Security Income, and participates only to a limited extent in various important Federal programs for the needy such as AFDC, Medicaid, Medicare, food nutrition and others.

These exclusions are particularly unfortunate, Mr. Chairman, because those in poverty in the island disproportionately comprise the elderly, children under 18, and single parent female headed families.

Mr. Chairman, today as yesterday, the poorest of the poor in the Nation are in Puerto Rico.

I have dwelt to some extent on these facts because it is in their light that we can say that the administration's budget proposals, if approved by Congress, would have a disastrous impact on Puerto Rico.

It is surely not a budget proposal that takes care of the truly needy. As far as we are concerned, it would only serve seriously to aggravate what is already a very dismal situation in the island.

Particularly damaging to us would be the President's recommendations regarding the following programs, all of which either provide essential assistance to the poor in Puerto Rico or else have had a great track record in helping to create employment on the island, UDAG, CSBG, CDBG, subsidized housing and housing rehabilitation programs, EDA, SBA, AFDC, Medicaid, child nutrition programs, wastewater treatment grants, Job Corps, elementary, secondary, and higher education, juvenile justice, public transit programs and legal services.

Especially hard for me, Mr. Chairman, is the President's recommendation regarding Puerto Rico's Nutrition Assistance Program. In fiscal year 1982, Puerto Rico was taken out of the national Food Stamp Program and was granted a special block grant at a funding level 25 percent below what the island was getting then. At that time, Puerto Rico had to remove approximately 100,000 needy families from the island's assistance rolls in order to adjust to the substantial reduction in funding.

And if substantial reduction in funds had not been enough, for 5 fiscal years—from 1982 to 1986—the Puerto Rico Nutrition Assistance Program was not granted any increase for inflation despite the fact that food costs in Puerto Rico grew annually all those years at a rate that is higher than that of the mainland.

In fact, over the past 5 years, the accumulated increase in food costs has substantially diminished the buying power of an already substantially reduced Nutrition Assistance Program. Thus, if the reduced block grant remains frozen, it will provide 41 percent less for food purchases in fiscal year 1987 than what the Puerto Rican

needy would have obtained if their Food Stamp Program had not been replaced with the cap and unadjusted block grant.

This gross inequity was partially corrected by this House last year in the farm bill which was signed into law, which provided a modest cost-of-living increase for the Puerto Rican Nutrition Assistance Program. However, Mr. Chairman, the President, now ignoring the law that he himself signed, is now proposing that the cap for the Puerto Rican block grant be kept in fiscal year 1987 as it has been during the last 5 years.

Mr. Chairman, I plead with the committee to ignore the President's proposal to repeal the cost-of-living adjustment that was enacted into law last year.

To conclude, Mr. Chairman, I wish to ask the committee's support for the budgetary recommendations approved and submitted to you by the full House Interior and Insular Affairs Committee regarding two specific items pertaining to Puerto Rico. Both of them are petitions to restore funds to the island that were unduly cut in the fiscal year 1986 budget.

One deals with funds improperly sequestered by GAO under the Gramm-Rudman legislation. Contrary to what I believe was the congressional intent, GAO applied the legislation in question to Internal Revenue collections from Puerto Rico. It subjected to reduction excise taxes and custom duties that the Federal Government has collected without alteration for Puerto Rico since 1900 and which fund part of the national and international commitments of the United States to the Commonwealth of Puerto Rico.

I think urgent action is needed to clarify this matter and to insure that full payment of these collections is made to Puerto Rico, as required by Public Law 600.

Likewise, a reimbursement is also clearly justified in relation to the reduction of nearly $5 million in the fiscal year 1986 appropriations for the Puerto Rican Food Nutrition Block Grant. That reduction was inadvertently made and is contrary to the mandate three times issued by Congress and the President that the Puerto Rican block grant cannot be diminished; when the block grant was established in 1982 through Public Law 97-253, when it was again reauthorized by Congress last year through Public Law 99-198, and again in the Balanced Budget and Emergency Deficit Control Act of 1985 when it was expressly exempted from sequestration.

In all these laws, it was clearly set out that the block grant is of a fixed amount, not subject to reduction. Urgent action is needed here to correct what is obviously an error.

Thank you, Mr. Chairman. I know that the claims and requests of the people of Puerto Rico will receive fair and compassionate consideration by your committee.

[The prepared statement of Mr. Fuster follows:]

PREPARED STATEMENT OF HON. JAIME B. FUSTER

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In spite of the very dire economic circumstances of the island, Puerto Rico does not participate at all in several major federal assistance programs, such as General Revenue Sharing and the Supplemental Security Income; and participates only to a limited extent in various important Federal programs for the needy such as AFDC, Medicaid, Medicare, food nutrition and others. These exclusions are particularly unfortunate, Mr. Chairman, because those in poverty in the island disproportionately comprise the elderly, children under 18, and single-parent female-headed families. Mr. Chairman, today as yesterday the poorest of the poor in the nation are in Puerto Rico.

I have dwelt to some extent on these facts because it is in their light that we can say that the administration's budget proposals if approved by Congress would have a disastrous impact on Puerto Rico. It is surely not a budget proposal that takes care of the really needy. As far as we are concerned, it would only serve seriously to aggravate what is already a very dismal situation in the island.

Particularly damaging to us would be the President's recommendations regarding the following programs, all of which either provide essential assistance to the poor in Puerto Rico or else have a great track record in helping to create employment on the island: UDAG; CSBG; CDBG; subsidized housing and housing rehabilitation programs; EDA; SBA; AFDC; Medicaid; child nutrition programs; wastewater treatment grants; Job Corps, elementary, secondary and higher education, juvenile justice, public transit programs and Legal Services.

Especially disheartening, Mr. Chairman, is the President's recommendation regarding Puerto Rico's Nutrition Assistance Program. In fiscal year 1982 Puerto Rico was taken out of the national Food Stamp Program and was granted a special block grant at a funding level 25 percent below what the island was getting then. At that time, Puerto Rico had to remove approximately 100,000 needy families from the island's assistance rolls in order to adjust to the substantial reduction in funding.

And, as if such substantial reduction in funds had not been enough, for five fiscal years, from 1982-1986, the Puerto Rico Nutrition Assistance Program was not granted any increase for inflation, despite the fact that food costs in Puerto Rico grew annually all those years at a rate that is higher than that of the mainland. In fact, then, over the past 5 years the accumulated increase in food costs have substantially diminished the buying power of an already substantially reduced nutrition assistance program. Thus if the reduced block grant remains frozen, it will provide 41 percent less for food purchases in fiscal year 1987 than what the Puerto Rican needy would have obtained if the Food Stamp Program had not been replaced with the capped and unadjusted block grant.

This gross inequity was partially corrected by this House last year in the farm bill which was signed into law, which provided a modest cost of living increase for the Puerto Rico NAP. However Mr. Chairman, the President, ignoring the law that he himself signed, is now proposing that the cap for the Puerto Rican block grant be kept in fiscal year 1987 as it has been during the last 5 years. Mr. Chairman, I plead with the committee to ignore the President's proposal to repeal the cost of living adjustment.

To conclude Mr. Chairman, I wish to ask the committee's support for the budgetary recommendations approved and submitted to you by the full House Interior and Insular Affairs Committee regarding other two specific items pertaining to Puerto Rico. Both of them are petitions to restore funds to Puerto Rico that were unduly cut in the fiscal year 1986 budget. One deals with funds improperly sequestered by GAO under the Gramm-Rudman legislation. Contrary to what I believe was the Congressional intent, GAO applied the legislation in question to internal revenue

collections for Puerto Rico. It subjected to reduction excise taxes and customs duties that the Federal Government has collected without alteration for Puerto Rico since 1900, and which form part of the national and international commitments of the United States to the Commonwealth of Puerto Rico. I think urgent action is needed to clarify this matter and to ensure that full payment of these collections is made to Puerto Rico as required by Public Law 600.

Likewise, a reimbursement is also clearly justified in relation to the reduction of nearly $5 million in the fiscal year 1986 appropriations for the Puerto Rican food nutrition block grant. That reduction was inadvertently made, and is contrary to the mandate three times issued by Congress and the President that the Puerto Rican block grant cannot be diminished. When the block grant was established in 1982; through Public Law 97-253; when it was reauthorized by Congress in 1985 through Public Law 99-198 and again in the Balanced Budget and Emergency Deficit Control Act of 1985, Public Law 99-177, where it was expressly exempted from sequestration in all these laws it was clearly set out that the block grant is of a fixed amount not subject to reduction. Urgent action is needed here to correct what is obviously an error.

Thank you, Mr. Chairman, I know that the claims and requests of the people of Puerto Rico will receive fair and compassionate consideration by your committee.

Mr. LOWRY. Thank you, Mr. Fuster, for a very effective and informative statement. I know this committee is going to look very hard at these important items you bring up.

The gentleman from Florida.

Mr. MACKAY. I want to be sure I understand the last substantive paragraph on page 5. Are you saying that the block grant was reduced by $5 million, although the Gramm-Rudman bill did not touch it?

Mr. FUSTER. Yes; the Gramm-Rudman bill expressly protects the Puerto Rican Food Nutrition Assistance Program. And as I have already mentioned, in 1985—in fact, December 18, 1985—the Congress approved, in the new farm bill, an adjustment for inflation. But to my surprise and the surprise of many of my colleagues in the Agriculture Committee, the next day in the continuing resolution that was approved—December 19, 1985—the across-the-board six-tenths of 1 percent reduction for all agricultural programs was applied to Puerto Rico. It was applied to all the Agriculture Department programs across the board.

We have never had a separate appropriation unit for that fund and it was the understanding of members in that committee that this should not have applied to Puerto Rico.

But unfortunately, Agriculture Department has not understood it that way and they have informed us and informed the Government of Puerto Rico that they need congressional clarification in order to be able to exempt Puerto Rico from that six-tenths of 1 percent cut that was applied in the continuing resolution to all of the agricultural programs.

Mr. MACKAY. I see. All right. Thank you very much.

Mr. LOWRY. Thank you very much for your excellent testimony.

Congressman Visclosky, thank you for coming and joining us and waiting.

STATEMENT OF HON. PETER J. VISCLOSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. VISCLOSKY. Mr. Chairman, you have not saved the best for last.

Mr. Chairman, I want to thank you and the other members of the committee for this opportunity to express my views. I appreci-

ate the chance to address the budget and the overall policy that I believe the committee should adopt.

I would like to start my remarks by describing the district I represent. Without injecting partisanship, mine can be described a traditional Democratic district. One out of every two households in my district has a member of organized labor living in it; 23 percent of the population is black. About 8 percent is Hispanic. Most everyone else is—like me—either eastern or southern European.

We make more steel in two counties in northwest Indiana than in any other State in the country. Our area, and the people in it, have been devastated and savaged by an economy that is in transition, and by a Congress and an administration that appears to lack the will to address the problems that we face. Something must be done.

As a percentage of the gross national product, the public debt of the United States was 34 percent in 1980. In the last few years it has increased to approximately the mid-40 percent. By fiscal year 1990, it is projected that the public debt of the United States will represent 54 percent of the Nation's GNP.

We must balance the budget, but we must do it by establishing priorities. We must not become a country that simply buys tanks, mails pension checks, and pays interest at the bank.

I think that we should begin by accepting the target for deficit reduction that has been set for fiscal year 1987 at $144 billion. In preparing the economic assumptions to meet that target, I believe we should exercise a great deal of conservatism, and err on the side of underestimating the growth of the economy.

Additionally, I believe that we would achieve that goal, no matter what.

To accomplish this feat, we should begin by cooling our rhetoric. Shortly after the President submitted his budget, Joseph Wright from the Office of Management and Budget addressed a number of Members of Congress. One of his initial remarks—and it was certainly understandable—was that "no one wants to talk about Social Security." After the meeting, I approached him privately to let him know I was one Democrat who was willing to talk about Social Security. The first step is to calm our rhetoric.

Second, I think that we should talk to each other as parties. I think that the Democratic Party should seriously sit down with the Republican Party and talk about taxes and Social Security. The Republic Party, in turn, should sit down with the Democratic Party and talk about taxes and defense. And then we should talk to the American people.

Instead of promising more money and less taxes, we must explain the need for real restraint and appeal to each citizen for the higher values of acting for the good of all. It is time that we told the citizens of this country when they complain about Federal taxes, that yes, we take on average 19 cents out of each pocket. But we return an average of 25 cents to that pocket, and it is this situation that cannot continue.

I think most fundamental is that we be decisive. We should be honest with the American people and we should act. I am tired of listening to conversations with other Members who express an in-

clination for inactivity because no constituency exists, either to increase taxes or to reduce spending.

I think that to be honest, everything must be on the table. Every means-tested and non-means-tested program should be on the table. Every entitlement program—all 90-some-odd entitlement programs starting with Social Security—should be on the table. Taxes should be on the table. Every defense program should be on the table.

At a senior citizens fair I held in Highland, IN, several weeks ago many complained about the threat of a freeze on Social Security. I pointed out to the attendees that transportation had been provided for them to get to the senior citizens fair. Many of them had to leave by the noon hour because they were going to receive a subsidized meal at a different location. Many of them live in housing that is subsidized. And the list of programs go on.

I asked them, what does it gain you to receive those extra few dollars in entitlement, if we can no longer provide these other programs.

Recently 100 postmasters from the State of Indiana came in and said there were two bills pending to rectify the inequities of Gramm-Rudman. They thought they had an easy mark in Peter Visclosky because I had opposed Gramm-Rudman. I stood up before those 100 postmasters and said that I agreed with them that Gramm-Rudman was unfair, and that I mean to see it made fair. I told them that I would want to see all COLA's frozen, with a reasonable set aside as provided by the MacKay-Slattery-Leath amendment for those who are in genuine need, who are at the margin and who depend solely on their benefit check.

When the postal workers come in today supporting that same legislation, or when the American Legion comes in next week asking that Gramm-Rudman be made fair by giving them more money, I will also tell them no.

I feel that the American people are looking to us for decisiveness in solving this problem. Although the situation is politically complicated, in a sense the solution is relatively easy—if we are honest, and if we are decisive, and if we put everything on the table.

Mr. Chairman, I do appreciate this opportunity.

Mr. LOWRY. Thank you. We have had excellent testimony from Members of Congress today, but I think it is possible we saved the best for last. That was excellent, and the people of northwest Indiana are very well represented.

I know you are familiar with the low-income problem on the COLA freeze. I certainly do not have to explain that to you; you could explain that to me. And that is why you mentioned some sort of a set aside, such as the SSI plough back or something.

We, of course, have also been considering—and there has been considerable studies on a proposal by which the Social Security benefits would be taxed on a larger amount than presently are now—and you are familiar with that proposal. Again, looking at an equitable way by which to avoid what I think every Member of this Congress wants to avoid, which is hitting the $5,000 total income Social Security recipient. That is what we are trying to do. What would be your position on a tax approach to equity to Social Security?

Mr. VISCLOSKY. I would support that approach. I think that it is a more equitable solution because it is a progressive, as opposed to a regressive type of a system. The freeze-everything approach is very regressive, and I certainly acknowledge that. It is a sloppy way to legislate. But we are at a desperate point. However, if it were feasible, I think that a tax approach is really the best approach to take.

Mr. LOWRY. Thank you. The Congressman from Florida.

Mr. MACKAY. Mr. Visclosky, I cannot tell you how refreshing it is to have someone come before this committee and say we really ought to get on with this. You sat here for most of the last hour, as I have, and the chairman has been here for a great deal longer than that. And I am not sure about this, but I think you may be the first Member of Congress who has come in today and said we can do this. It should be done across the board and it should be fair, and we should get on with it.

Frankly, I think that this committee is more and more coming to that conclusion, although it is not yet clear what the committee will do. I applaud you for taking the time to do this and I believe you are out front on an issue and you are where the Congress has got to be. Thank you very much.

Mr. VISCLOSKY. Thank you very much.

Mr. LOWRY. Thank you, Congressman Visclosky.

Anything else to come before this committee? If not, we stand adjourned. Thank you.

[Whereupon, at 4:41 p.m. the committee adjourned until 9:30 a.m., Wednesday, February 26, 1986.]

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IMPACT OF THE PRESIDENT'S 1987 BUDGET

WEDNESDAY, FEBRUARY 26, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee), presiding.

The CHAIRMAN. The committee will now come to order.

Today we welcome Federal Reserve Chairman Paul Volcker. He has come before us as he does each year to testify on the relationship between fiscal policy and monetary policy and the prospects for improving economic performance.

We had a disappointing year in 1985. Economic growth was a meager 2.3 percent, productivity growth was zero, and the trade deficit set another new record at nearly $150 billion. However, this poor performance is largely the fault of fiscal policy, not monetary policy.

The deficits caused by this administration's tax and military spending policies are the cause, I believe, of the increase in the trade deficit, while the poor productivity performance reflects the failure of those tax policies to deliver on their promises.

The Federal Reserve addressed the needs of the slowing economy in a constructive way by abandoning the administration's fetish of M1 growth targets, allowing interest rates to come down, and by working with Treasury Secretary Baker to reduce the value of the dollar—again, reversing the previous policy of the administration, which welcomed an overpriced dollar and refused to intervene in the foreign exchange markets.

If our prospects are better going into 1986, it is largely because of these monetary policy actions. This year, both the passage of Gramm-Rudman and the constitutional questions about its application create new problems and uncertainties for the budget process.

The prospect of sequestration late in the year if a budget is based on a faulty economic forecast means that it is more important than ever to use realistic economic assumptions. More important, questions have been raised about whether the Federal Reserve is able and willing to let interest rates decline. This is needed to offset the negative effect on the economy of the expected Gramm-Rudman deficit reduction in fiscal year 1987.

It is somewhat disquieting that last week Chairman Volcker revealed that the danger of a slide in the dollar is working against further reductions in short-term interest rates.

We are looking forward to your further clarification of these crucial issues, Mr. Chairman. Again, we welcome you to the House Budget Committee. Please summarize your testimony. It will be entered into the record. If you would summarize, we will have more time for a question-and-answer period.

At this time I would like to call upon the ranking minority member of the committee, Congresswoman Lynn Martin, for an opening statement.

Mrs. MARTIN. Good morning. We are pleased to have you here, Chairman Volcker. We keep reading about you, so seeing you in real life, not just on the cover of magazines, is a rare pleasure.

I am surprised to hear the chairman of the Budget Committee say that he didn't think last year went that well. I thought last year was a very good year. He is not going to listen, but eventually he will.

Mr. Chairman, since I am going to mention you, I will have to interfere with that conversation.

The CHAIRMAN. Please forgive me. I was talking to a distinguished colleague——

Mrs. MARTIN. From Minnesota.

The CHAIRMAN. From Minnesota.

Mrs. MARTIN. A friend of the farmer and an important member of the Budget Committee.

I just said I was surprised to hear you say you did not believe last year had gone that well for America. I had thought that with you as the new chairman of the committee, we had entered a new era of achievement and improvement and that you and Chairman Volcker were part of that same Reagan revolution that has produced so much fiscally and, I hope, monetarily.

I too look forward to your testimony, Mr. Chairman. I look forward to hearing not just what you think we should do, which is much, but what you, too, see in the future of monetary policy, especially real interest rates and how they affect important parts of our economy, from international trade to agriculture.

Again, our welcome from both sides of the aisle. Many of us have disagreed, but that disagreement has never stifled our great admiration for you.

Mr. VOLCKER. Thank you.

The CHAIRMAN. Thank you, Congresswoman Lynn Martin. I am sorry I didn't have greater feelings about 1985. I was with my colleague, Congressman Kemp, in expecting 4 percent growth. Therefore, I was sadly disappointed when it was 2.3 percent and not the expected 4 percent.

Chairman Volcker, we welcome you to the House Budget Committee. We invite you to summarize your opening remarks.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman.

My statement is already a summary of material that we have sent you, our semiannual report and my testimony before the Banking Committee last week, which deals with monetary policy in some detail.

I will read, with your permission, at least parts of my short statement this morning and try to put that in some context.

I do say the past year was one of further progress in the Nation's economy. The growth of domestic production slowed, but the rise in output still was sufficient to generate 3 million new payroll jobs and to reduce the unemployment rate significantly further.

Moreover, and I think it is terribly important, growth was sustained consistent with maintaining the progress that had been achieved on the inflation front.

I do think the prospects for extending the economic advances of the past year appear by and large to be good as we move into 1986. Latest reports on employment, industrial production, and housing activities show further increases around the turn of the year.

Confidence appears well maintained, cost increases have been restrained, and interest rates, particularly in the long-term area, have moved significantly lower. The sharp recent declines in the oil price, given the weight of energy in the economy, appear to assure a favorable price performance in the months immediately ahead.

My statement does discuss very briefly the target ranges that we set out and considerations of monetary policy. I will leave further discussion of that for your questions.

I would note that, in setting our own projections, members of the Federal Reserve Board and Reserve Bank presidents do anticipate somewhat faster growth this year than in 1985 and continuing reductions in unemployment.

Views on inflation were more diverse, with some expecting additional slowing while others anticipating a moderate pickup from last year's inflation rate.

The so-called central tendency of these projections for real GNP and for inflation both are generally a little lower than the administration's forecast. They were about 4 percent for both real GNP and prices, somewhat closer to the growth projections of the Congressional Budget Office. The differences are not large, and if you take the full range of expectations expressed by Board members and bank presidents, it encompasses both the administration's and the CBO's figures.

I would note that while prospects appear to be generally favorable, there are some very important uncertainties and points of strain. We have discussed many times the trade and fiscal deficits. They are still with us. But there is a potentially crucial difference from the situation a year ago.

The actions by the Congress and the administration on the budget now carry the clear promise of progress toward better budgetary balance in the years ahead. At the same time, a substantial adjustment in exchange rates has occurred during the past 12 months, improving the competitive position of American firms and, over time, that should contribute to a reduction in our trade deficit.

At the same time, we have to understand that to make good on both developments—substantially reduce budget and trade deficits—we will need to have hard and persistent efforts over the considerable period of time. In the meantime, financing both deficits will require a large, continuing net inflow of funds from abroad.

That is why we always keep in mind the need to maintain confidence in our currency and the potential inflationary effects of rapid depreciation.

I think a clear appreciation in the marketplace of improved prospects for the deficit has been a major element of protection against those risks and will continue to be. That is why I so much welcome the efforts the administration, the Congress and this committee have made to place the budget deficit on a declining trend.

All of that requires very difficult decisions. I am not in a position to advise you on all those intensely political questions of where spending should be cut, but I have indicated many times before, and I will repeat it again, that from an economic perspective, the performance of the economy over time in terms of efficiency and incentives tends to be better served by approaching deficit cutting from the spending side rather than the tax side.

Only if sufficient spending cuts cannot, in fact, be enacted to place the deficit on a solidly declining trend does the question of any substantial action on the revenue side become relevant.

As I indicated, I think you can already see some of the benefits in improved market sentiment. Intermediate and long-term interest rates have declined sharply in recent months. Interest rates generally are at the lowest level since 1979, and the stock market is continuing to set new records.

Although other factors have played a role in these developments, certainly lower oil prices recently, the prospects for budgetary restraint clearly have been one critical factor. I think the effects of the lower interest rates are beginning to be felt, certainly in the housing market, and lower rates and higher stock prices should assist other private investment decisions as well.

In the short run—and this addresses a question you addressed to me, Mr. Chairman—as they become effective, deficit-reduction actions, taking account of their direct impact, restrain the growth of income and potential economic activity. Those direct effects may, of course, be balanced by other economic developments, and you would ordinarily expect them to be; for example, you would include, in part, the beneficial effects of lower interest rates stimulated by the budget reductions themselves.

The precise balance of these forces is hard to foresee. At present, for instance, the decline in oil prices itself is releasing purchasing power to the American consumers. In any event, the balance of those forces, both currently and prospectively, is an important element in the judgments we must make on monetary policy.

I don't know any way to express realistically a kind of mathematical tradeoff, however, in the light of all the crosscurrents.

I also note in the statement that, apart from the general trade and budget problem, we have pervasive pressures in important sectors of the economy. Certainly that is true with the agricultural sector, where conditions are very difficult. Key manufacturing industries continue to face strong competition.

In financial markets, a number of institutions have had to cope with loan problems associated with sectoral economic pressures, the large debt burdens of some borrowers, and the disinflationary process itself.

Beyond the implications for monetary policy, this poses challenges for banking supervisors and other public policymakers. You have responded to that in part through the farm bill. I noted the decline in the foreign exchange value of the dollar will help bring about an environment in which American producers will be able to compete more effectively, and we supervisors have been encouraging depository institutions—and they themselves have been moving—to bolster capital and reserves to help strengthen their ability to cope with strain.

I am not going to argue that we have in place every policy to prepare for every eventuality. A number of questions remain, including the strength of economic expansion abroad—and I would emphasize that factor—the impact of a declining dollar on American inflation and the effect of lower oil prices on the financial health both of domestic energy producers and of a number of oil-exporting developing countries.

But I do believe adverse shocks in these areas or others should be manageable if there is a cooperative effort among all the involved parties here and abroad.

I do note, because you asked whether there were any unforeseen or obvious effects from the Gramm-Rudman sequestering on the financial system, that these across-the-board cuts hurt the good and the bad alike in that they do limit our ability—not only our ability, the ability of other regulatory authorities—to increase, as we have planned, our supervisory effort because that does involve some manpower. But we are going to proceed within the Federal Reserve to give that area as much priority as possible.

In sum, Mr. Chairman, I do believe that substantial progress has been made over the past year. We also have to recognize we still have some distance to travel, but we have come too far and the stakes are too high to fail to meet those challenges now.

Thank you, Mr. Chairman.

[Testimony resumes on p. 780.]

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I appreciate the opportunity to appear before this Committee today. As you know, the Federal Reserve submitted its semi-annual monetary policy report to the Congress last week. That report, which we have distributed to you, describes in detail our plans for monetary policy, including the Federal Open Market Committee's ranges for growth of money and credit. A copy of my statement to the Banking Committees has also been provided. My prepared remarks this morning will be brief and confined to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The past year was one of further progress in the nation's economy. Although the growth of domestic production slowed last year, the rise in output still was sufficient to generate 3 million new payroll jobs and to reduce the unemployment rate significantly further. Moreover, growth was sustained consistent with maintaining the progress that had been achieved on the inflation front.

As we move into 1986, the prospects for extending the economic advances of the past year appear, by and large, to be good. The latest reports on employment, industrial production and housing activity show further increases around the turn of the year. Confidence appears well maintained, cost increases have been restrained, and interest rates, particularly in the long-term area, have moved significantly lower. The sharp recent declines in the oil price, given the weight of energy in the economy, appear to assure favorable price performance in the months immediately ahead.

In this context, the Federal Open Market Committee at its meeting earlier this month reaffirmed the tentative ranges it had established last July for the broader monetary and credit aggregates, M2 and M3. For M1, the target range was widened to take account of the greater uncertainty surrounding the behavior of this aggregate, but the mid-point of the range was the same as tentatively agreed six months ago.

In deciding upon these ranges, the Committee understood that particular uncertainty had surrounded the recent behavior of M1 and its velocity. Consequently, evaluation of the significance of changes in M1 will continue to be made in light of the trend in the other monetary aggregates. Moreover, evaluation of the outlook for business activity and prices, as well as conditions in domestic and international markets will, as in the past, contribute to the operational judgments of the Committee in determining the proper degree of pressure on reserve positions.

Consistent with this approach and the ranges set out, members of the Federal Reserve Board and the Reserve Bank Presidents expect that the economy will grow somewhat faster this year than in 1985. Views on the outlook for inflation were more diverse; some expected additional slowing, while others anticipated a moderate pickup from the 1985 inflation rate. The "central tendency" of the projections of real GNP and inflation for 1986 generally is a little lower than the Administration's forecasts

of about 4 percent each, and is closer to the growth projections of the Congressional Budget Office. However, the differences are not large. Indeed, the full range of expectations expressed by Board Members and Bank Presidents does encompass both the Administration's and the CBO's figures.

Although prospects for economic performance in 1986 appear favorable at this time, there are inevitably some important uncertainties and points of strain. The two major, and interrelated, imbalances that I have stressed so often in the past -- the enormous trade and fiscal deficits -- remain. But there is a potentially crucial difference from the situation a year ago. The actions by the Congress and the Administration on the budget carry the clear promise of progress toward better budgetary balance in the years ahead. At the same time, a substantial adjustment in exchange rates has occurred during the past twelve months, improving the competitive position of American firms and over time contributing to a reduction in our trade deficit.

At the same time, we have to understand that both developments -- substantially reduced budget and trade deficits -- will require hard and persistent efforts over a considerable period, measured in years. In the meantime, financing both deficits will require a large continuing net inflow of funds from abroad. That is a major reason we must keep in mind the need to maintain confidence in our currency and the potentially inflationary effects of rapid depreciation. A clear appreciation in the marketplace of improved prospects for the deficit are a major element of protection against those risks, and that is why I welcome the efforts made by the Administration, the Congress, and this Committee to place the budget deficit on a declining trend.

I recognize that reducing the deficit requires difficult decisions. From my particular position, I will refrain from responding to your invitation as to where specific budgetary cuts should be made; that process involves intensely political choices entirely in the domain of the Congress and the Administration.

As I have indicated many times before, from a purely economic perspective, the performance of the economy over time in terms of efficiency and incentives tends to be better served by approaching deficit-cutting from the spending side rather than from the tax side. Only if sufficient spending cuts cannot in fact be enacted to place the deficit on a solidly declining trend does the question of substantial action on the revenue side become relevant.

The potential benefits of smaller budget deficits already can be seen in improved market sentiment. As you know, both intermediate- and long-term interest rates have declined sharply in recent months, interest rates generally are at the lowest level since 1979, and the stock market has continued to set new records. Although other factors have played a role in these developments -- for example, lower oil prices -- the prospects for budgetary restraint clearly have been a critical factor. The effects of lower interest rates are beginning to be felt in housing activity, where sales of single-family homes are at a six-year high

and housing starts are up most recently. Lower rates and higher stock prices should assist other private investment decisions as well.

In the short run, as they become effective, deficit reduction actions, taking account of their direct impact, restrain the growth of income and potential economic activity. Those direct effects may, of course, be balanced by other economic developments, including in part the beneficial effects of lower interest rates, stimulated by the budget reductions themselves. The precise balance of these forces is hard to foresee -- at present, for instance, the decline in oil prices itself is releasing purchasing power to American consumers.

The balance of these forces, currently and prospectively, is, of course, an important element in the judgments that we must make on monetary policy, but I know of no way to express realistically a kind of mathematical "tradeoff" in light of all the cross-currents in the economy.

Trade and budget deficits are not the only imbalances that pose uncertainties for the economic outlook. Pervasive pressures remain in much of the agricultural sector, and key manufacturing industries continue to face strong competition from foreign producers. In financial markets, a number of institutions have had to cope with loan problems associated with sectoral economic pressures, the large debt burdens of some borrowers at home or abroad, and the disinflationary process. Beyond implications for monetary policy, this poses challenges for banking supervisors and other public policies; the recently enacted Farm Bill, for instance, will provide substantial elements of support for the agricultural sector. As I noted earlier, the decline in the foreign exchange value of the dollar will help bring about an environment in which U.S. producers will be able to compete more effectively in world markets. And the efforts of many depository institutions to bolster capital and reserves should help these institutions to cope with financial strain.

It would be foolish, of course, to think that we have prepared in advance for every eventuality. Indeed, a number of questions remain, including the strength of economic expansion abroad, the impact of a declining dollar on U.S. inflation, and the effect of lower oil prices on the financial health of domestic energy producers and of a number of oil-exporting developing countries. But adverse shocks in these areas, or others, should be manageable if there is cooperative effort among all involved parties here and abroad.

Mr. Chairman, you asked me to comment on any areas of federal spending in which across-the-board spending cuts could have disruptive effects in financial markets. Given our particular responsibilities, I must in that connection note that the ability of the Federal Reserve and other bank regulatory agencies to add resources to our supervisory efforts will inevitably be impacted. While voluntarily complying with the spirit of Gramm-Rudman-Hollings legislation, we intend to limit the impact of cuts in that high

priority area as much as feasible. Our sister agencies, in some instances, may have less flexibility.

This strikes me as one example of the need to make the hard budget choices as a matter of considered national priority rather than falling back on inevitably arbitrary "across-the-board" sequestering procedures, however important the latter may be in encouraging discipline.

Let me conclude my remarks by noting that we at the Federal Reserve share common goals with the Congress and the Administration -- maintaining sustainable growth of economic activity in a context of greater price stability. Substantial progress has been made over the past year. We also have to recognize that we still have some distance to travel, and that indeed the effort is never ending. But we have come too far, and the stakes are too high, to fail to meet the challenge now.

The CHAIRMAN. Thank you very much, Chairman Volcker.

Because of Gramm-Rudman this year and the requirements of hitting a fixed target and also the threat of sequestration, many of us are concerned about economic forecasts in a way that we have never been concerned before. In the past, we have taken our best estimates, best guesstimates, and that has been it. Now, under Gramm-Rudman, we cannot allow that to happen. We must try to be as accurate as possible.

We note that both CBO and the administration are above the central tendency FOMC forecast of real GNP growth. Wouldn't it be more prudent for us to use a more conservative forecast that fell within the FOMC central tendency boundaries?

Mr. VOLCKER. You are dealing with an imperfect art, and you are quite right that the Gramm-Rudman-Hollings legislation puts a lot of emphasis on precise numbers, which in turn can be affected by the economic outlook—not simply real growth, but also the inflation rate, the level of interest rates, and other factors. None of those can be forecast with enormous accuracy. The record shows that.

There is nothing that has happened in the science of economic forecasting in the past year that meets your need for more accurate forecasts, and you're going to have to live with the fact that forecasts have a range of uncertainty.

We have expressed, collectively and individually—this is nothing but a collection of individual forecasts—our views. The central tendency is a little lower, but as I pointed out in my statement, some individuals have forecasts not only as high as the CBO but as high as the administration, or even higher.

So, I do not know how to advise you on that score. The weight of it has been a little bit lower, as you say.

The CHAIRMAN. Mr. Volcker, Craig Roberts has written in the Wall Street Journal that "the new projections of deficits declining to around $100 billion by 1991 are not dependent on any policy changes such as tax increase or implementation of Gramm-Rudman."

However, you have been quoted as saying that those calculations are "very fragile" and "will require some very hard choices by Congress." Would you explain why the Roberts statement is wrong or you differ with it?

Mr. VOLCKER. I do not recall the Roberts statement, or the exact context, but I would certainly repeat with emphasis what I just said about a 1-year forecast. Those forecasts, 5 years ahead, are dependent upon what might better be called assumptions, rather than forecasts. And that is inevitable, that you have to sit down and make some assumptions, draw the conclusions based on how things exist at the moment.

But I think we have had a lot of history, and I do not think any of those forecasts—the ones that I have seen—from the administration or the Budget Office allow for any new spending initiatives. They assume things are in place.

There is some disagreement, as you know, about the defense assumptions, which in itself makes a large difference. There are certain assumptions about interest rates and other factors.

Just let me make two points. First, a 5-year forecast and all the records of 5-year forecasting show that you cannot assume these projections are automatically going to come about. Second, if you are going to have that kind of expenditure restraint, I suspect that that is just going to take a continuing effort by the Congress to, in fact, exert the restraint necessary to meet those figures.

And that is all I think I was trying to say.

The CHAIRMAN. You were quoted the other day, Chairman Volcker, as saying that there is a great difference between assuming deficit reduction and actually reducing the deficit. Today——

Mr. VOLCKER. The same point.

The CHAIRMAN. Yes; the same point.

Today, CBO releases the reestimates of the President's budget. They find that he misses the Gramm-Rudman deficit target by about $16 billion in 1987 and $40 billion by 1991 and that there are only $21 billion in real spending cuts in 1987.

From your perspective, does this seem to imply that we need to cut $16 billion more? What amount should be the target? Last year you gave us a target of $50 billion.

Mr. VOLCKER. Let me say I have a little difficulty with the concept, as I am sure many of you do, of setting a precise numerical target for a deficit years ahead.

Given the uncertainties that I just mentioned, my understanding is that you adopted that procedure for good and sufficient reason; this was a way to get maximum discipline on your spending decisions, which is a goal that I strongly share.

Just how it comes out, in terms of a precise number for a precise fiscal year is another matter. But you have objectives in the law, numerical objectives, which are partly dependent not only upon your actions but, as you were just indicating, the performance of the economy, the performance of interest rates, and all the rest.

And, in concept, if you take the actions that are necessary on the basis of reasonable projections, I personally wouldn't worry about whether the precise budget targets were met. But I understand you have that in the law.

And I think that is a decision you are going to have to face up to.

Certainly I assume we would all agree that the best way to approach this is not just to let it lapse and have to go to the sequestering procedure in place of an informed judgment by the Congress as to the areas that it wants to cut to meet the spending target.

And I guess I would emphasize the spending target, because the revenues are going to be affected—not so much in 1 year, but over a period of years—by the rate of growth, and the spending will be affected by interest rates and other factors.

The CHAIRMAN. Thank you very much, Chairman Volcker. The gentleman from New York, Mr. Kemp.

Mr. KEMP. Thank you, Mr. Chairman.

Welcome, Chairman Volcker.

I do not want to ruin your day, but I agree with your statement recently that it is a very serious mistake for U.S. Treasury officials to be taking the risk of talking down the dollar. The dollar, it seems to me, in support of your statement should be stabilized.

Of course, there is a broad disagreement as to how to stabilize it, but my question is with regard to 1985, that in 1985—last summer

the budget deficit projection was I think $229 billion for fiscal year 1987 according to OMB. I forget what CBO was, but it was in that range.

Interest rates came down. They came down specifically on long- and short-term instruments. You mentioned it in your testimony. And as yet, Congress has not acted on the deficit. Yet, the deficit projections alluded to in the Wall Street Journal article read by Chairman Gray, those were actually quotes of the CBO analysis of where the deficit was headed by 1991 if there were continued progress on interest rates and the economy and all those factors that you mentioned are so important to the budget.

Is there any chance that interest rates and short-term instruments could continue to come down, given the fact that one, it has had such a beneficial impact upon projected deficits in the future; second, it has been beneficial to housing and autos and particularly beneficial to Third World debtor nations? Why is not now a good opportunity to be taken by the Fed to ease up on say the discount rate and to get that very important continued progress not just on the budget but on the industrial sector and particularly on the farming sector, which is going through a commodity price deflation unmatched in our recent history?

Mr. VOLCKER. You have cited some factors that I think are favorable toward interest rates, and there are some that you did not cite so directly. Much depends upon the inflation outlook, which I think in the short term is good. There is a risk, from the dollar side, that you at least implied, if you were not explicit about it.

Another factor is the rate of growth of economic activity, whether higher or lower.

You, yourself, emphasized the fact that interest rates have been going down. In the long-term area, the extent of that decline recently is really quite remarkable.

So, things have been moving broadly in that direction, and I think we would all like to see interest rates lower. If we can balance out the various factors and risks involved, the one factor on the other side is the dollar situation. There are some others, but that is one fact on that side, and you started off your statement with that concern.

Mr. KEMP. Well, my—just to elaborate on it, with factory utilization rates at about 80 percent and 8.5 million Americans still unemployed and farm prices, commodity prices, energy prices, labor contracts, oil prices—you alluded to—the consumer and wholesale and producer price indexes have all been favorable, it seems to me that we should be looking at markets to determine when we ease or tighten rather than those abstract targets that heretofore have been used, such as M1 or M2 or even the monetary base.

Do you agree or disagree, or find anything favorable to react to, in new Director Wayne Angel's suggestion that we ought to look directly at some basket of prices to go directly to whether or not there is inflationary or deflationary expectations in our common goal of reaching our stable currency and a stable price level?

Mr. VOLCKER. I think it is a matter of emphasis. I think that is one thing to be looked at. As you know, commodity prices can be very volatile. Oil, as a commodity, is by far the most important commodity and oil prices are way down right now. Other commod-

cties declined during much of last year. They may be more or less stable now, but at a much lower level. And that has certainly been a favorable expectational signal, a favorable signal in fact on the inflationary side, and it is, in my mind, a factor to be taken into account.

You mention the monetary aggregates, and I should have mentioned them earlier. Obviously, we express our policy in those terms. We had very rapid growth in M1 last year, as you know. We did not respond to that aggressively, as you also know. When interest rates went down, we didn't respond to that aggressively in the general context that the broader monetary aggregates, M2 and M3, were not expanding; that is, they were expanding, but reasonably within our target limits. So that is another thing to look at.

Most recent movements in M1, though looking at a very brief period, have shown more stability.

Mr. KEMP. What are the chances, do you think—this is my last question, because the red light went on. What do you think the chances are of seeing a favorable analysis by the group of five finance ministers with regard to some effort at the industrial nation level, to coordinate more closely the exchange rates of the world in order to boost our trade and keep our liberal and indeed, make them open in terms of future markets?

Do you hold out the prospect that that is a possibility?

Mr. VOLCKER. When the President of the United States raises this issue in his State of the Union Message, I think it will be taken very seriously by the others. There are certainly some considerable differences of opinion on this matter, but I think it will certainly get discussed seriously.

And in my statement before the Banking Committee, which I did not repeat here this morning, I explicitly said that I welcomed that initiative and that I do agree that exchange rates have been extremely volatile and that we ought to be looking at approaches that promise more stability, recognizing, at the same time, all of the difficulties in that, which we have discussed on previous occasions.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from New York, Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Chairman Volcker, we will probably consider some sort of a revenue increase. We probably will not enact an increase, but I would like to have your opinion of the variety of energy taxes that have been talked about. Which, in your opinion, does the least harm to the economy and might be a direction we should look to? An oil import fee, a gasoline tax increase between 10 and 15 cents, or broad based energy increase of Btu tax? Do you have a preference among those?

Mr. VOLCKER. I do not consider myself any expert on energy taxes, to say the least. But I have thought some about this. And I had raised the question of an energy import fee before this committee a couple of years ago, in the eventuality of a sharp decline in oil prices.

Well, we have had a sharp decline in oil prices. As I look at that issue now, it seems to me that particular kind of measure ought to be considered basically only in the framework of its contribution, if

felt necessary, toward a longer range conservation effort and exploration supporting effort. I do not think it is ideal, to say the least, or even very good if thought of as a revenue-gaining measure for a variety of reasons.

It is hard for me to see, in current circumstances, that we would want to have an oil import fee that did not exempt some of our close trading neighbors that are very heavily dependent upon oil exports. Once you do that, it takes care of so many of our imports that you have not got many revenues left.

But it would seem to me very hard to impose this tax on Canadian or Mexican or even Venezuelan or Ecuadorian exports to us, when they have counted on our market. We have encouraged that. They have already got enough financial difficulties. It does not seem appropriate to me, as I look at the situation.

The oil import fee also raises very difficult questions of administration; there would be demands for exemption and all of the rest.

So I think if that becomes desirable, it is desirable as a conservation measure, not as a revenue measure. And perhaps if the oil price got low enough and there were enough concern about that, it ought to be considered, but only in that light.

It is also true that if you had to raise revenues you could raise a considerable amount of revenues with a tax on gasoline or a tax on energy usage generally, at a time when the energy price is going down and you have an offsetting impact on the inflationary aspects of that.

Much more generally, I would say if you had to turn to revenue measures—and I propose that you do it by the spending side, let me make that clear——

Mr. DOWNEY. Yes, I understand.

Mr. VOLCKER. You would look for taxes, I think, that bear more heavily on consumption rather than on incentives, and I suppose the energy tax falls in that broad category.

Mr. DOWNEY. I do not want to—nor could I—put words in your mouth, but of the three does the gas tax seem less onerous in terms of its economic impact than the other two that I mentioned?

Mr. VOLCKER. I just do not think that I am expert enough about all of the differences. I do not want to be pinned down that——

Mr. DOWNEY. Could I ask you about some of the dark parts of the silver cloud? What do you foresee—and again, given the general optimistic attitude that we have, we tend to plan and think that this growth is going to last forever. What developments do you believe could lead to a recession in the next few years?

Do you believe that the forcing of the Gramm-Rudman targets could trigger such a recession?

Mr. VOLCKER. I would doubt that, because you get offsetting benefits to the economy that are profoundly important. One could imagine certain economic circumstances in which the timing might not be ideal, but I would say that the general thrust of those efforts is constructive rather than the reverse.

We do have financial strains and pressures at home and abroad. One of my principal concerns is that we have been, during this expansion period, which is now more than 3 years old, basically the motor for the world economy. I don't think we can persist carrying so much of that load in the United States without continuing or

even aggravating the imbalances that have developed, particularly on the trade side.

So when one looks in that longer time perspective, or even a fairly short time perspective, it does seem to me terribly important that the major industrial centers in Europe and Japan exhibit more growth and take whatever action is necessary to support that growth.

I might point out in that connection that both Japan and countries on the Continent of Europe, in particular, are major beneficiaries of the oil price decline. They are relatively bigger importers than we are, and of course, they get all the favorable price effects. On top of that, they have had a very rapid appreciation of their currencies, which is a very strong force toward restraining prices there.

So their price outlook is extremely favorable now in Germany and Japan. Where the question lies is on the growth side.

Mr. DOWNEY. Let me ask you one brief question on trade legislation. The Ways and Means Committee will look at sometime this year doing a major trade bill. We have talked about, though I certainly hope we won't do a 25-percent tax, a tariff on some of our trading partners if we continue to have trade imbalance with them.

What is your opinion of such a tariff and what recommendations would you make, if any, to the Ways and Means Committee as it begins the process of writing a trade bill?

Mr. VOLCKER. I can understand the feelings of frustration that led to that discussion last summer. With this change in exchange rates and given the world situation, I don't think there is any excuse for that kind of action at this time, and I think it would be wholly destructive.

If you want a recession, given the situation we are in already with questions about growth abroad, with the very severe pressures in Latin America and elsewhere growing out of their particular problems, with the debt problem compounded for some of those countries by the decline in oil prices, and recognizing they can only deal with those problems constructively by exporting to us and to other countries, both the substantive effects and the message that goes out with that kind of action, I think, would very clearly fall into the category of the kind of threat that you were asking about. If you want to produce a recession on a worldwide basis, that might be a good way to go about it, but I don't think that is the object of the game.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Michigan, Mr. Wolpe.

Mr. WOLPE. Thank you very much, Mr. Chairman.

There are two questions I would like to put to you, Chairman Volcker. The first relates to the economic impact of different kinds of spending cuts. Do you see any differences in the economic impact, strictly speaking as an economist, from spending increases, let's say, on the military side versus spending increases in areas of education or domestic program expenditures?

Mr. VOLCKER. There are long-term effects, and economists will get very sophisticated about trying to identify different short-range effects depending upon the type of expenditure—whether it is for investment goods, whether it is for transfer payments, or spending

for goods and services. I think those all tend to be second order effects in the short run.

Look at a particular situation, for example, defense spending. If you had a lot of bottlenecks in the defense goods-producing industries and they were pouring out a lot of additional spending in that area, you would have a more pronounced inflationary effect than if that weren't the case.

But apart from those particular kinds of situations, which would depend upon a factual situation as a first order effect, I wouldn't worry too much where the spending cuts were in terms of the effects on the total economy over the next year or two.

Now, the long range is something else, again. You get into something like education. One of the disturbing things about the economy, as the chairman mentioned in starting, is that we didn't have any productivity growth last year. I don't know if I quite believe that, to what degree that is a reflection of the inherent difficulties of measuring the quantity and quality of services, but however much allowance one makes for measurement difficulties, it is disquieting to see productivity grow so anemic at this stage.

That bears upon the long-range potential of the economy. It bears upon whether it is realistic to think in terms of as high a growth as may have been projected over the next 5 years. If you just looked at that one year, now, I don't think we should overreact to one year's statistics—these are very difficult statistics—but it is not on the plus side.

Mr. WOLPE. You raised an interesting point when you cite the productivity rate referencing to, I think, some of the proposed reductions in assistance to higher education, the reduction in the area of job training. Is it not the case that some of those reductions in investments in what might be described as the human capital area could well impact negatively on America's international competitiveness over the longer term?

Mr. VOLCKER. You would think so, but that gets to the question of how efficient those programs and how effective those programs really are, and you are getting outside my depth when you get to that area.

Mr. WOLPE. No, let's assume for the moment that the issues—you haven't raised the efficiency factor in appraising other kinds of investments. What I am just trying to understand is, from an economist's standpoint, are not investments in human capital at least as important in terms of the new emerging international economy as investments in physical plant and equipment?

Mr. VOLCKER. From a broad economic standpoint, yes. That depends upon the effectiveness of the program; as the physical investment depends on the efficiency of that investment and whether it is really productive and all the rest. Human capital is very important.

Mr. WOLPE. But if one makes sharp reductions in human capital investments, is that likely to enhance or to diminish productivity in the future?

Mr. VOLCKER. It would depend upon how effective those expenditures are. And then you have to weigh it against the general benefits——

Mr. WOLPE. Let's assume for the moment that efficiency is a neutral factor, that everything is equally efficient or equally inefficient, just looking at that one issue of investments in human capital for the moment, holding constant the deficiency or the manner in which those investments are made.

Mr. VOLCKER. I guess I'm not going to hold that constant because you can't force me into a position that says if there are totally inefficient expenditures, just because they got that label they are terrific.

Mr. WOLPE. I understand that. I understand that. I am trying to get across the notion, though, is it really true that every cut in the budget has essentially the same economic impact?

Mr. VOLCKER. No, obviously not in the long run.

Mr. WOLPE. OK. And if you are looking at the issue of international competitiveness, would you not focus particular attention in this period upon our human capital requirements?

Mr. VOLCKER. That is certainly a factor I would take into account in shaping those programs, both the composition of the program and size of the program.

Mr. WOLPE. The last question I would like to put to you, Chairman Volcker, relates to a lot of the speculation that has been in vogue about the combined impact of declining energy prices and the agricultural crisis upon the strength of our banking system.

I would like to get your assessment of the numbers of banks that remain in trouble and your projections in terms of the near future, at least, of what might happen with respect to the international financial community and the banking sector.

Mr. VOLCKER. You have two quite different problems in terms of the agriculture and energy and international debt problems. They are both sources of strain, but one is heavily concentrated, if that is the right word, among a very large number of small banks and agricultural areas, and we have had more failures of those banks.

But I want to keep that in perspective. That failure is still a very small fraction of the total of those banks, and we are very fortunate—and I'm speaking just now of agriculture—that by and large those agricultural banks were in the strongest position of any American banks. They had good quality assets before the agricultural difficulties. They have high capital ratios and have generally shown good earnings over the years.

So they have been in a position, while under greatly increased pressure, to have a strength to withstand that, by and large, and I think that will continue to be the case, although undoubtedly you are going to continue to get some failures of agricultural banks, most of which are quite small-sized. But it is a big problem, potentially, for the communities in which they are located.

You have got a problem insofar as the banking system is concerned in a different direction, in the energy and international debt problem, where some of the larger institutions, not just in the United States but abroad, tend to have relatively heavy concentrations.

But let me make a couple of points in that connection. The international debt problem has been somewhat diffused. I don't want to minimize it at all. It is a very serious problem. But exposures are somewhat less today relative to capital by about 30 percent or a

third or so in that relative sense than they were in 1982 when the crisis first came upon us.

That crisis has been managed, I think, relatively effectively through a lot of efforts, beginning with the efforts of those countries themselves. I strongly believe that can continue to be the case even though some of those countries are put under great added strain from the oil price decline.

Let's not forget in that connection that some of those countries also benefit very considerably from the oil price decline.

So it is a very serious continuing problem that needs our attention and, I think, needs congressional attention, but I think it is manageable.

On the internal energy problem, that has also been a continuing problem for several years. It doesn't burst on us in a new way. And I would also point out that some exceedingly optimistic assumptions were made about oil lending in the late seventies and early eighties, and some of the weakest of those loans have already gone bad and been absorbed—with difficulty in some instances by the lending banks—but some of the weakest loans over the course of the last 3 or 4 years have already been taken care of.

So you have added strains in that area, too, but you have already had a shakeout, if that's the right word, of some of the most vulnerable lending activity.

Mr. WOLPE. Thank you very much.

The CHAIRMAN. The time of the gentleman has expired. The gentlewoman from Illinois, Mrs. Martin.

Mrs. MARTIN. I must admit until today I hadn't fully realized some similarities between you and Secretary Weinberger. Privately, I will be able to tell you.

I wonder if you could be specific about something, and that is what you believe would be responsible for the EC and the Japanese to do in terms of bearing a fairer share of the load of world leadership, both in terms of the interrelationships of our currencies, especially to the yen and the deutschmark, and then what you think they should do now that quite obviously they are going to have some goodies in terms of perhaps even fiscal, not just monetary policy.

Mr. VOLCKER. I would put the emphasis, whether it is fiscal or monetary policy, on the point that I made earlier. In Europe as a whole, unemployment rates have been running between 9 and 10 percent, on the average, and in some countries they are substantially higher than that, so they really have a lot of room to grow. Their price outlook is very favorable now, and I think the greatest contribution that they can make to the world trading system and the continuation of the general economic advance would be to take advantage of this opportunity to grow a little more rapidly and use some of this——

Mrs. MARTIN. Well, how? I doubt if any of them don't want to grow. Do you think they should lower taxes, as we have done, to propel growth?

Mr. VOLCKER. I have said that, yes. I think they have got some opportunity to do that. As realists, they have been extremely concerned about their own budgetary problems and have put an enormous amount of priority on improving their budgetary situation. I

am hardly in a position to criticize that effort, although from my particular vantage point, I think perhaps some tax reduction would be good.

As a practical matter given their political processes today, I don't know how much flexibility they have on that score.

Mrs. MARTIN. Continuing, as I really am trying to get a feeling of what they can do because I think there is certainly bipartisan agreement they should be doing more. Could it be, for instance, that one of the things they would do and it would add even within jobs, perhaps bearing a greater share of their defense load, or allowing more open markets?

Mr. VOLCKER. We only were on point one. On the open markets, I would certainly agree with you. Defense has been a long argument over decades, as you know, and I would certainly agree with the general sentiment that lies behind your question. I don't count on changes in policy in that area over the next year or two as having any pronounced effect. It has been a very long discussion.

But I certainly think they have the opportunity to move toward opening markets, and I would put even more emphasis on Japan and on Europe, but I think there are opportunities in both cases, when one looks at the situation I mentioned earlier, the need for the developing countries to expand their exports, which we encourage them to do, to grow out of their problems. They can't grow out of their problems and have a more efficient economy without export markets.

One is struck with how much of their export market—particularly for manufactured goods, which is where they have got to make progress in the future—comes to the United States rather than to Japan and Europe.

It seems to me that is an area that could be critically important in the next year or two.

Mrs. MARTIN. I know from your own writings, you certainly don't support the idea of quotas or import fees. I think or I hope I hear you saying that we should be asserting a great deal more pressure on these close allies of ours to take their place in the world and to take some of the pressure off us which is certainly hurting, especially certain segments of our economy more than others. Would that be correct?

Mr. VOLCKER. Yes.

Mrs. MARTIN. How would you suggest we put that pressure on them?

Mr. VOLCKER. In saying "yes," I had one reservation. You said "more pressure." I think the administration is trying to do just that. I might say "continued."

Mrs. MARTIN. Your testimony over this last year was a joy to listen to.

The CHAIRMAN. The time of the gentlewoman has expired. The gentleman from Texas, Mr. Frost.

Mr. FROST. Mr. Chairman, in March 1983, you told this committee that if oil dropped below $25 a barrel, that would be the time to impose an import fee. It has, of course, dropped substantially below that figure. Do you still have that view, or if not, what is the appropriate per barrel figure when we should have an import fee?

Mr. VOLCKER. Mr. Downey asked me that question and I responded to it earlier. I would note that when we were talking hypothetically about $25 a barrel, I think the price of oil was well above $30, and it had gotten down to that area before this most recent decline. Given the situation today, as I indicated to Mr. Downey, and given the pressures that exist on Mexico and some of the other oil exporting countries, an oil import fee that limited their access to our market doesn't strike me as a good idea.

Mr. FROST. Mr. Chairman, assuming that we exempted Mexico.

Mr. VOLCKER. Then it becomes a matter of long time conservation, I think. If the oil price is so low that it is just building up pressures for a sharp reversal sometime in the future, then that is the context in which I think that discussion becomes relevant. I'm not sure it is there, but that is the discussion that would be relevant.

Mr. FROST. Mr. Chairman, what is the per barrel price? You said a specific price several years ago.

Mr. VOLCKER. I don't feel very confident in my judgment on that score right now. I have consulted with a number of people who presumably are much wiser than I in the oil markets. I detect nothing but great uncertainty about that. I'm not going to leap in where others fear to tread.

Mr. FROST. Mr. Chairman, are you concerned about the destruction of the domestic oil industry in this country? Would we have to wait until it gets down to $5 a barrel?

Mr. VOLCKER. That is the kind of thing that you would weigh—that together with the conservation issue. As you say, yes, the oil industry is going to be destroyed at $5 a barrel, to take an extreme case, and that is going to contribute to nothing but future instability in the oil price and make us vulnerable. That is the kind of situation in which that tax becomes very relevant.

Mr. FROST. Mr. Chairman, aren't there national security considerations, too, that if we destroy the capacity of this country to produce its own oil, that we become totally dependent upon oil from the Middle East?

Mr. VOLCKER. If you make that kind of extreme assumption, then I would agree the question becomes relevant.

Mr. FROST. Mr. Chairman, you did not embrace either the other taxes that Mr. Downey suggested, either the gasoline or the Btu tax. You are just not enthusiastic about those taxes?

Mr. VOLCKER. I said I didn't want to make a choice between them. I said if you had to go to revenues, which is not my preference, but if you had to go to revenues, those are certainly taxes you would look at, I think. I have no basis for choosing between them.

Mr. FROST. You are not excited about either one of them?

Mr. VOLCKER. I would rather see you do it by expenditure reduction.

Mr. FROST. I understand. Assuming that we can't get there from here, assuming that there is going to be some sort of tax considered by this particular committee at some point, would you prefer we look somewhere else other than at gasoline or Btu tax?

Mr. VOLCKER. You can design an ideal tax system if you had years to do it. If you were doing something immediately that was

administratively feasible and so forth, I think that is obviously an area where you would look.

Mr. FROST. Would you look at excise taxes on liquor and cigarettes? Is that something we should look at?

Mr. VOLCKER. Possibly; I'm not recommending any of those. Those are taxes in areas that, I think, are least damaging to incentives; yes.

Mr. FROST. Taxes are what would be considered nonessential items?

Mr. VOLCKER. Even cigars. [Laughter.]

Mr. FROST. Mr. Chairman, if we do find it impossible to reach the $144 billion figure, without going into revenues, we are concerned about the economic assumptions, too, because there is an interrelationship between the two. We are assuming right now, for sake of argument, you start with the 4 percentage point GNP growth.

If we are to be ultraconservative, if we are to use a lower figure than that, what would you recommend we use, if we didn't use 4 percent? If we really wanted to be very conservative and make sure we didn't miss the $144 billion figure, what should we consider?

Mr. VOLCKER. I think that is a matter of philosophy. If you want to assume absolutely optimum performance in setting that target, then you go toward the higher end of the range and at the risk that you don't meet it. There is something to be said for that approach. I don't think you want to be so conservative that you are busting everything to meet that target even in a weak economy. You can go someplace in between. I wouldn't overdramatize the effect on next year's budget of whatever assumption you make for 1986, particularly since to some degree you might normally expect some offsetting effect on the receipts generated by growth, higher in a strong economy, and the expenditures saved by lower interest rates, usually lower in a weaker economy.

I don't think that some of these differences might be quite as dramatic just looking at one year. They get more dramatic as you look out to 1991. They obviously make a very large difference. The difference is the one-half percent change in the growth assumption, which is not dramatic in any one year time perspective.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Leath, who is not in the room. The gentleman from California, Mr. Fazio.

Mr. FAZIO. Thank you, Mr. Chairman.

Mr. Volcker, the other day we had some economists before us. Alan Blinder of Princeton was one of them. He told us that as far as he was concerned, the sale of assets that make up a large section of the one-time savings that are factored into the President's budget submission, are in an economic sense utterly meaningless. He indicated that as far as he was concerned, whether those assets were held by the private sector and they would obviously have to float loans in order to make those acquisitions or whether we simply held them ourselves and derived the benefits from the income from them over the years really didn't matter and it was a rather artificial way of making the deficit reduction task look far less difficult for Congress and obviously to get the administration off the Gramm-Rudman target dime.

Could you comment on that economic perspective?

Mr. VOLCKER. I don't know that I would share the sweeping nature of his statement. Asset sales by and large, in terms of their impact on the credit markets, are going to be similar to Government financing. They absorb the available supply of credit. I think that is the point he was making.

There may be other reasons why you want to get Government out of some of those businesses and not have direct Government financing and that may be perfectly valid.

I would simply say you judge the reasonableness of that approach against the other objectives being sought.

Mr. FAZIO. Again, it comes down to a matter of philosophy, perhaps, or politics?

Mr. VOLCKER. I think it is true that, as I say, on the credit absorbing side, I basically take his point. You wouldn't want to see all this deficit reduction and expect to have the same effects on credit markets if you did it all by asset sales, because it wouldn't have the same effect on credit markets.

Mr. FAZIO. That is correct. We have a very confusing and perhaps inadequate budget document in terms of our method of doing accounting. Would you want to comment on that?

Mr. VOLCKER. I would just make a general comment. It is a source of frustration through the years. You people like to work with a single figure: Total expenditures and total revenues. In fact, not all expenditures as assessed in that document have the same economic and fiscal meaning. You can deal with this by having a much more complicated document which separates out loan programs from other types of expenditures, for instance, even investment expenditures from other types of expenditures; then you are working with a document that doesn't have any single, presumably unambiguous, figure for you to work with.

The difficulty is that that presumably unambiguous figure disguises a lot of ambiguities, and you have picked up an important one.

Mr. FAZIO. I would like to focus for a minute on the question of total debt. As I understand it, right now we are about $1.60 in debts for every $1 in GNP but by 1995 on the current trend line, we will be talking about $2.25 of debt for each $1 of GNP. A lot of this debt is not in the public sector. It is in the private sector. In the last 4 years, we have 25 million more credit cards in circulation. We have seen the question of the secondary mortgage market zoom up in 5 years from $40 to $150 billion.

Is there a problem in this country with debt period that we ought to be worried about and perhaps ought to be looking at tax policy from the standpoint of a solution, if you think there is a problem?

Mr. VOLCKER. Yes, I think there is a potential problem here which I have spoken about on a number of occasions. It is very hard to pick any particular ratio—I think it is impossible, not only hard. I can't point to any particular ratio as being some kind of a flashpoint or danger point. I have certainly noted that trend. I haven't extended it through 1991 where it would really get all out of balance with any historical experience and apply a tremendous amount of leveraging and debt load.

I am not going to read this recent trend, which is now over 2 or 3 years, as extending through 1991.

One of the problems I think does lie in the tax structure; I don't think there is any question about it. Looking at private debt, we tend to have a tax structure that favors borrowing and is biased against equity. You have the additional problem of whether some particular tax incentives may not give rise to certain types of activities that are extremely highly leveraged.

I would recommend that the Congress look at that and correct those imbalances. I think they lead to a more fragile financial structure than we would have otherwise. I think it is an important question to which you should be devoting more attention.

Mr. FAZIO. Mr. Volcker, I thought I would conclude by asking you to see if you could clarify once again where you and Secretary of Treasury Baker stand on bringing the dollar down. There was an exchange of views in opposite committees in both Houses last week that brought some confusion to the markets and even the Members of Congress as to whether or not it was appropriate to see the dollar decline in relative terms more or not any longer. I think we need to have some effort to discuss on the record how you feel about this.

Mr. Baker told us when he was here the other day that he doesn't feel troubled by having so much foreign capital here. He didn't think that was bad at all. He thinks we only ought to worry about how it is utilized. We argue about that. I wonder if you would comment?

Mr. VOLCKER. I don't think we have any substantial difference of opinion. In those statements that we made, we emphasized two sides of the same phenomenon. Most phenomenon are two-edged swords. That is certainly true of the exchange market. The dollar had been extraordinarily high and it undercut our competitive position. I don't think there is any doubt that some correction had to be made, and there is a substantial correction that has already been made. I don't know whether that is enough over a period of time or not, but I know it is substantial.

The other side of the danger is we have had some experience here and elsewhere of currencies beginning to decline; it may be constructive, but then they overdo it. It brings inflationary problems, and it potentially brings problems in credit markets generally. I was emphasizing that danger of overdoing it.

One aspect of overdoing it is you reach the point where people lose confidence in your currency, and that investment flow that we need will not come so easily. Looking at that over a long period of time, he is certainly correct; if foreign capital is used constructively to increase productive potential, it can be useful. One can question the sustainability of capital flows of the size that we are now relying upon and I don't think we want to be in a position of relying upon that amount of capital flow year after year after year.

Mr. FAZIO. It can't go on forever.

Mr. VOLCKER. That is right.

The CHAIRMAN. The gentleman from Minnesota, Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Chairman Volcker, I would like to follow up on the line of questions that Congressman Kemp, among others, initiated because he

referred to the deflation of commodity prices and specifically referred to the problems in the agriculture sector. And that is the part of the country that I represent.

As you know, the suffering is really very severe in agricultural America today because of a deflation of commodity prices across the board. And that is true not just in agriculture, of course, but as Congressman Frost and others alluded to, there has been general deflation in commodity prices over the last year.

My question to you is this. In late 1984—I believe it was December—you indicated that some loosening of Fed policy was appropriate at that time. And among the factors that you cited was a softening of commodity prices. Now since—if you look at what has happened between that time and today, commodity prices have softened further. Some of them have softened an awful lot, like oil prices and also agricultural commodity prices.

I realize you take other things into consideration, GNP growth, inflation, inflationary prospects and things like that. But in view of the fact that we have experienced further deflation in commodity prices since you made that statement in late 1984, doesn't that indicate that policy probably is still too tight and we need some further easing?

I am leading the witness, but I want to lead the witness.

Mr. VOLCKER. I suppose all I can say is that I think policy has been broadly appropriate, taking account of all of these various factors. Commodity prices throughout 1985–86 have not done much but still remain at that low level. Broadly, through 1985, they were declining, whether they were in agriculture or other things, and that certainly has been a factor.

To get a little technical here, M1 ran very high last year. If you look at M1 alone and if you took a purely monetarist's view, you would say policy was widely expansionary. We looked, among other things, at those commodity prices, and we concluded that policy was not widely inflationary and that, indeed, in some sectors of the economy there was a deflation going on.

Now I do not want to lose perspective here. When one looks at agriculture, in particular, I think there are some very profound structural things going on around the world. Our farmer is a world producer and he is being affected by what is going on around the world and that is quite beyond, in a structural sense, anything that monetary policy can do.

It is kind of a two-edged thing, like the exchange rate. I suppose we welcome the fact that China produces much more in agricultural products now and that India is self-sufficient and all the rest. But that rebounds back on our farmers.

Mr. WEBER. Let me just ask you generally then, do you continue to be concerned by the fallen commodity prices, without dictating that that is going to change policy?

Mr. VOLCKER. Certainly it is one of the things that I look at. I will tell you that.

Mr. WEBER. You can probably tell what policy prescription some of us would lead to. The too! that you have at your disposal is the discount rate and there has been a lot of discussion about what you may or may not do with that, but as I understand it, Japan has just cut their discount rate. Germany is probably in the process of

doing so, which will put us three or four points above that, in terms of that indicator.

Is it not really time to make a further reduction in the discount rate?

Mr. VOLCKER. We take all these considerations into account and make a judgment.

Mr. WEBER. Thank you. I have an additional question, if I can follow through.

Some of your more encouraging comments, at least for me—I think your whole testimony has been somewhat encouraging—but I am really encouraged by your favorable comments about the international initiative taken by Secretary Baker and by the administration. Your comments were welcome there.

I wonder if you can define your views on that subject a little bit further, because there is a debate going on in the economic community about the desirability of floating exchange rates? Dr. Friedman and others argue that floating exchange rates are appropriate because they implement free market policies which indicates that we should just look upon currencies as another commodity and allow them to float.

I am glad that the administration is not taking that point of view. I look forward to our moving closer to a fixed exchange rate. What is your view on that whole subject and specifically, should we be looking upon currencies just as another commodity?

Mr. VOLCKER. I do not look at currencies as just another commodity. It is—for many countries, maybe for the United States—the most important single price and it has implications for the performance of our economy in many directions.

Beyond that, my concern would be at looking at the instability of exchange rates, the wrenching effect that it has on us and others, maybe more on others than ourselves. When you have exchange rates moving through the cycles that they have moved over the past decade, that is what concerns me, and it seems to me that we ought to at least be willing to look at possibilities for achieving more stability.

I do not want to underestimate the difficulties at all because it comes down to very basic policies. Floating exchange rates are kind of a convenient technique for saying we cannot get together on what we all should be doing collectively, and we all need a substantial amount of internal autonomy and we will let the exchange rate fall out of that equation.

But then we find the exchange rate, if it is very unstable, comes back and affects us and we really do not have that autonomy. But there are very deep economic and political problems in stabilizing the exchange rate because then you really do have to get into the questions of domestic policy posture.

Mr. WEBER. Are those problems insurmountable?

Mr. VOLCKER. No, I just do not want to make you think they're easy.

Mr. WEBER. But technically, we can achieve that?

Mr. VOLCKER. I think so, yes. We ought to try anyway.

Mr. WEBER. I guess I am out of time. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from South Carolina, Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Chairman, we are delighted to have you before the committee.

Let me ask you, and you may have covered this, at least on the peripheral edges. Last year, when you were before the committee and, as I understand, in some recent testimonies from economists in the last couple—what I am concerned with is do you consider that the $180 or $200 billion deficits that we have been running over the last several years have been a substantial stimulus to the economy?

Mr. VOLCKER. I think, on balance, they have stimulated the economy, but they have had side effects that move in the other direction, through their effects on the interest rate and on the trade balance.

My problem is that I do not think that situation is sustainable. Therefore, it has to be corrected, whatever the short-term effects.

Mr. DERRICK. On the other side of the equation, as Gramm-Rudman-Hollings takes effect and we cut down supposedly—or hopefully—on this, you have indicated that you do not see a great reverse effect of this happening. Am I to understand that you do not see the reverse of that happening and therefore you do not feel that it will be necessary over the next little while, in view of the austerity, that that probably would bring about to stimulate the—to ease the monetary policy?

Mr. VOLCKER. The reason I do not see any great effects from it is I think that action itself, and other actions that may accompany it, would produce offsetting effects, which would be on the favorable side and ending up with a better structure of the economy.

For instance, we would hope over a period of years, it is not going to happen tomorrow—to see a decidedly improving trade balance. That provides stimulus to the economy. You are not going to get that, in my judgment, unless you relieve that pressure from the budget deficits.

So there is your big offset, and that should come about in the context of lower interest rates than you otherwise would have.

Mr. DERRICK. So what you are really saying is you do not perceive the need for it?

Mr. VOLCKER. No, that is correct. I not only do not perceive the need for that kind of continuing stimulus, but think, in fact, it would be dangerous to rely on that stimulus.

Mr. DERRICK. One other question, if I may. Back when you appeared before this committee last year you indicated that we are all aware that a substantial part of our deficits are being financed by foreign capital. And you were very concerned, at that time, about the confidence factor and the fact that large amounts of that money might be pulled out at sometime because of the perception of a lack of confidence of this being a favorable place to invest.

From your testimony this morning and what I have been able to pick up out of the media and whatnot, you said last year that it was not a matter of whether it would happen but it was a matter of when. And the quicker we got about our business of reducing these large deficits, the less of an impact it would have.

Do you still feel as iffy about this situation? Are those still your thoughts this year?

Mr. VOLCKER. I think you have made some progress this past year on the budgetary side. I did not say it was inevitable that we lose this confidence at all. I think if we did not take appropriate actions, that this continued reliance on high capital inflows would sooner or later bring about its own destruction.

Well, what has happened since then? Potentially, we have this brighter budget outlook, which is clearly on the favorable side. We have, if we can control the effects, a much better competitor position and a better outlook for our trade balance, and we now have this oil situation coming along, which is favorable.

We are still vulnerable, but we have used this past year to begin putting in place or have happen things that are necessary to make those adjustments that I thought were necessary.

Mr. DERRICK. I certainly would not presume to put words in your mouth, but are you in fact saying that Congress has been responsible—at least in starting last year—I would try to get a positive note——

Mr. VOLCKER. I certainly think that you have moved aggressively on the budget. I do not want to say that that job is over, but you have moved aggressively and that is very helpful.

Mr. DERRICK. No one is suggesting that, Chairman Volcker. We thank you for even being willing to go that far.

Mr. VOLCKER. That is pretty far.

The CHAIRMAN. The time of the gentleman has expired. The gentlewoman from California, Ms. Fiedler.

Ms. FIEDLER. Welcome, Mr. Volcker.

I have a couple of questions for you. Could you please tell me what will the joint impact of the passage of the tax bill and the implementation of Gramm-Rudman do in the event the tax bill should pass sometime during the course of this year? Do you think that it would be disruptive, to some degree? Do you think it would be positive? Could you just reflect a little bit on how you feel?

Mr. VOLCKER. On the tax reform bill?

Ms. FIEDLER. Right; the combination of the implementation of both.

Mr. VOLCKER. I really cannot comment much on the tax reform bill because I have not attempted to follow that in any kind of detail. I know there are very serious questions about the impact that could have on investment from a rather rapid withdrawal of a lot of incentives and the net change in emphasis on the tax from the consumer side to the investment side, which concerned me a bit, particularly in their transitional phase. I recognize there are many difficult questions there. But I do not think I can comment further than that.

On the kind of broad expenditure restraint called for in Gramm-Rudman, I think that that can be absorbed and will, on balance, be helpful in terms of our overall economic activity.

Ms. FIEDLER. I think it would be helpful for us if we had, after upon reflection, some kind of a response from you or your organizations that would give us a sense as to what the joint implementation might be, since later on in the year we may have to deal with that combination of decisions. And I think it would be very helpful for us.

Mr. VOLCKER. I will try to see what we can do. I kind of hate to try to pronounce expert judgment or have even the Federal Reserve pronounce judgment on those very complicated issues of tax reform that are not really in our bailiwick.

But if we can amplify a little bit what I said, I would be glad to try that.

Ms. FIEDLER. Thank you. We appreciate that.

Could you tell me what impact will the lowering of oil prices have on worldwide investment and economic growth?

Mr. VOLCKER. You know the standard answer to that question is it has a very favorable impact over a period of time. It obviously has a very adverse impact in the short run, on the energy producing sectors. And how that balances out, in the very short run, is hard to foresee.

That gets back to this earlier question, what if they got so low that you were just building up a head of steam for further increase? But I would think if we have lower energy prices and can sustain them—and let us assume it is sustainable—it certainly is favorable on the inflation side. It is a favorable factor on the interest rate side. It is favorable for economic growth generally. But I do not want to minimize those problems that economists pass over as transitional for the energy industry; energy accounts for a good deal of our investment in total, and in other countries as well, and there is an impact on oil exporting countries.

Ms. FIEDLER. Do you have any sense at all as to whether or not you feel that oil prices are going to stay low or decline or whether or not they are going to rise?

Mr. VOLCKER. I certainly am not going to project what they are going to do in the very short run, or even this year, from the current level. It has been extremely volatile. But I read, as a lot of other people do, about changes in attitudes by experts in this area who only a few years ago were projecting further pressures on the oil market, indefinitely into the future.

Now they all seem to agree that we have—let us say a 5- to 10-year period anyway—a supply of oil that seems to be quite adequate relative to projected needs and there should not be the kind of strong upward pressures we saw a few years ago.

Ms. FIEDLER. The decline in demand for oil, what impact do you believe it will have on our balance of trade?

Mr. VOLCKER. That has immediately had a mechanical, physical impact of some size, because we'll import a lot of oil, and we'll import it at a cheaper price, and so that will, in itself, be a factor reducing the trade figures. But when you get beyond that very direct and mechanical impact, I'm not sure that I would see in the oil situation itself large secondary effects that would improve our trade balance. Don't forget, other countries are benefiting from this, in some ways relatively more than we are.

It will reduce everyone's costs. It will reduce our costs, but it will reduce our competitors' costs, too. So I don't think there will be large secondary impacts from that factor alone. The primary impact is obviously favorable.

Ms. FIEDLER. Thank you very much. I have no further questions.

The CHAIRMAN. The time of the gentlewoman has expired.

The gentleman from Illinois, Mr. Russo.

Mr. RUSSO. Thank you very much, Mr. Chairman.

After listening to all these questions and answers concerning the energy field, I'm ready to go home and start crying for the oil companies in this country. I think they're really in sad shape.

I find it kind of interesting that the energy companies, Mr. Volcker, in the days of the cartel price-setting were so strongly for the marketplace to set the price of oil, and all of a sudden when the market price of oil is going down, they're talking about pushing an import fee, so they can pass on their costs to the American people. At the same time, they send out the same message they did years ago, which is, "Drain America first. Use all our energy. Don't let any cheap energy in."

What do you think about the President's zeroing out of the strategic petroleum reserve, which was to protect us from cartels forming in the future, to prevent us being put under the gun when the cartels set whatever price they want for energy?

Mr. VOLCKER. I have a little question on that point. The budgetary constraint, I recognize, is very real. But if it was so urgent to have oil in that oil reserve when oil was $30 a barrel or higher, in principle, as a market man, I would say maybe one ought to look at it when it's $15 a barrel. [Laughter.]

Mr. RUSSO. Well, I would agree with you, Mr. Volcker. I think part of my problem is maybe the President kind of likes the oil industry and wants to make sure they're healthy and happy, because they're very good supporters of his.

I would challenge this administration and the members of this committee to fully fund the strategic petroleum reserve. Last year, I fought in this committee—I'm not from an oil State personally, but I thought Jack Brooks was right when he said we ought to put more money into the strategic petroleum reserve. We fought for it in this committee, and we got at least one-third funding. We set a dollar amount, and we said, "At least you can buy more oil in case it goes down," and the President returns and gives us a deferral on the strategic petroleum reserve.

I think the American people ought to know what is this gentleman's policy on energy when we have a time to be self-sufficient, when we can stock up to 6, maybe 9 months of reserves in the strategic petroleum reserve, to make sure that no possible cartel could ever get at us again.

The direction of this administration has been the wrong direction. And I think the point you made, if we thought it was important to put $30-a-barrel oil in the strategic petroleum reserve, it would seem to me that you ought to put as much of the $15-a-barrel oil in there as fast as you possibly could.

But again, I think that would be a nice article for maybe some of these investigative reports who have nothing to do these days, to look into some of these kind of things.

But it always amazes me that those people who have crocodile tears about the free market system, are not for the free market system when it costs them something. I'm glad to see that at least you're consistent.

Mr. VOLCKER. I think you have a case on economic grounds. I don't want to associate myself with the political analysis that you——

Mr. RUSSO. Oh, I understand that. [Laughter.]

That's why you're where you're at, and I'm where I'm at.

Let me just ask you one other question, Mr. Volcker. When you talk about your concern about these other countries' export markets, you're clearly very concerned about them. Who is concerned about our export market?

I have yet to have somebody come before our committee, either in the Ways and Means Committee or even the Budget Committee, who expresses a concern about our export market problems. We have problems. We have problems selling our grain overseas. We have problems entering the Japanese market in high technology. Why aren't the people who come before us concerned about our markets?

Mr. VOLCKER. I thought a lot of them were, and Mr. Downey was talking about the import fee———

Mr. RUSSO. Well, you don't serve on a trade subcommittee. If you did, you'd find out that what I'm telling you is more accurate than your comment that there are people who are concerned about it.

Mr. VOLCKER. We certainly have problems, and we ought to continue to work with our trading partners to make sure we have access.

Mr. RUSSO. Well, as my constituents say to me, I always wonder who the Commerce Department USTR represent. Do they represent the foreign governments or our Government? And sometimes sitting and watching trade policy over the last 5 years on that committee, I begin to wonder myself.

But let me just followup———

Mr. VOLCKER. I think they are making a very real effort, if I may say that.

Mr. RUSSO. Well, slow but sure. I think part of the reason that's happening is because of the pressure that's being put on by all the discussion for protectionism legislation. It is only being discussed out of frustration, because you can't get anywhere else with the administration on what to do with some of the specific problems we deal with, like steel and textiles for example.

You mentioned earlier, talking about foreign investment in response to Congressman Butler Derrick's question about wanting foreign investment to be used to basically finance half of our debt. Isn't that one of the reasons why interest rates don't come down in this country, because historically when inflation is around 3.4 percent, if history is any teacher—and maybe it isn't anymore in this economic situation—the basic interest rate has always been 2 to 3 points higher? Doesn't that mean in essence that we ought to be somewhere around 6.5 to 7 percent interest rates in this country?

Isn't that part of the reason we're trying to attract this foreign capital into our country? Or maybe the other answer is, the banks are just pigs.

Mr. VOLCKER. Complex circumstances, a big budget deficit and the related trade deficit and the need to rely upon foreign money, all affect the climate for interest rates. Those aren't the only factors. We've come through a big inflationary period.

But I've got to point out to you that interest rates, particularly long-term rates—and I think this is a remarkably favorable aspect in the economy now—have come down a lot recently.

Mr. RUSSO. Well, let me say, in 1975 when I first got elected to Congress, I think inflation was around about 6 percent, 5 or 6 percent, and I got a home mortgage at 8.25 percent. Now inflation is around 3.4 percent, and you go out to get a home mortgage, they're talking about 10.5 to 11 percent.

Mr. VOLCKER. I don't think there is any mechanical relationship between inflation and interest rates. But I think it is true that when inflation is accelerating, interest rates tend to lag the inflation. When inflation is decelerating, interest rates also lag the inflation. But they started out high and are coming down. It takes literally years to give people the confidence to want to invest long term when they've gone through a violent inflationary period, and we're still suffering from that to some extent, but the evidence is that we may be working through that.

Mr. RUSSO. Thank you.

The CHAIRMAN. The time of the gentleman has expired. The gentlewoman from California, Mrs. Boxer.

Mrs. BOXER. Thank you, Mr. Chairman.

Mr. Volcker, what country has an economy as healthy as ours or more healthy than ours?

Mr. VOLCKER. That probably is a controversial question. Our economy has been doing pretty well recently in the world league.

Mrs. BOXER. Well, I'm just asking you a question. I mean, I don't mean it to be controversial, but I just want to ask you that question.

Mr. VOLCKER. Everybody's got a certain amount of pride in their own country. But in recent years, certainly our growth rate, against our experience and in the world league, I think has made us the motor of this world recovery.

Now you can find some particular countries—small ones—that may have been growing faster. But given our weight in the economy, we've been at the top of the league in the last few years.

Mrs. BOXER. So, in your opinion, there is no other country whose economy is as healthy or healthier than ours in terms of deficits, in terms of investment, in terms of unemployment, in terms of all the factors that you would use to judge whether one's economy is healthy? There is no other country?

Mr. VOLCKER. There's one exception to that list of favorable factors that you point out. Both Japan and Germany, for instance, have a better price outlook than we do. And as you weight that into the equation, they're better off than we are at the moment.

Mrs. BOXER. A price outlook? That is, the prices are going down; is that what you're——

Mr. VOLCKER. In the wholesale area, they're probably going down, but they have, I think, a substantial outlook for stability in the consumer price area.

Mrs. BOXER. Let me ask you this. So, in your opinion, we have the strongest economy in the world. Now what are some of the weak points that you would like to see turned around? We know the deficit, and as you've agreed, we've started to work on that, and we agree on that. What about the percentage of savings of the average family? What are some other things we should work on?

Mr. VOLCKER. It's very low. In the world league, it's very low. It has been for years, and it's particularly low now. I don't put too

much weight on one year's statistic, but we invest less and save less than the typical industrialized economy, by a considerable margin.

Mrs. BOXER. OK. So, investment and savings are areas we ought to look at in general.

Mr. VOLCKER. Right.

Mrs. BOXER. Let me talk a minute about investment. When the President brought us his tax cut, one of the purposes was to encourage investment, and from what I've read, that really hasn't happened to the degree that he had hoped; and one of the reasons for the deficit is that there hasn't been that kind of wonderful effect on the economy of all this investment.

How does that relate to the mergers that have taken place? How do you feel about mergers in general in terms of mergers versus investment?

Mr. VOLCKER. I have nothing against mergers per se. I think you have a competitive situation out there. Fortunes change. Sometimes mergers can be good; sometimes they may not be. But that's up to the private judgment of those participating.

I have had some concern about the method of financing; it's not unique to mergers. You can have leveraged buyouts. You can have other means of leveraging a company without mergers. It's not peculiar to mergers. But I have been concerned about the degree to which equity is being retired in this economy and that debt that is being created, and I think over time that's not what the doctor ordered in terms of a really healthy financial system.

Mrs. BOXER. Do you think—let me just say a yes or no—that mergers have had a negative impact on investment?

Mr. VOLCKER. Neutral.

Mrs. BOXER. Neutral?

Mr. VOLCKER. I suppose you might argue that to the extent they're necessary, it may be positive.

Mrs. BOXER. OK. From what I gather from your testimony—tell me if I'm right on this—you admit that there are certain problems with commodity prices falling that have a regional impact, such as on the farmers, such as on the oil producing states.

Mr. VOLCKER. No doubt about that.

Mrs. BOXER. But your advice to us is that rather than take an approach where you change some of the factors in the economy, like the interest rates, to help these areas, that on balance it's better not to do that from the standpoint of the Federal Reserve policies, and look toward the bigger picture of the entire economy and avoiding inflation, et cetera.

Mr. VOLCKER. I didn't say that reduction in interest rates is bad. But yes, we have to look toward the bigger picture. And to the extent that these problems reflect things specific to those industries, they are beyond the reach of monetary policy.

Mrs. BOXER. OK. If that's the case—I just want to follow it up, Mr. Chairman—if that's the case, then would you say it's incumbent on the Congress to look at other ways to help these specific areas; in other words, not to look toward the monetary policy to help the farmers or the oil-producing states, but to look to ourselves in terms of what we can do for these regions?

Mr. VOLCKER. I think you did that in the farm bill, and I think that that's appropriate.

I would only give you one word of warning in that connection, that you don't want to take specific measures that don't deal with the underlying problems and just postpone the problem or paper it over without really going to the fundamentals.

But, of course, that's what Congress is here for, to look at those kinds of problems and see whether there is some constructive action you ought to be taking.

Mrs. BOXER. Thank you. You've been very helpful.

The CHAIRMAN. The time of the gentlewoman has expired. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman, and thank you, Chairman Volcker.

I think we're going to write a budget and pass a budget that hits the $144 billion target. I think we're going to do that. And within that, of course, we'll be making assumptions. Now assuming we use the most honest assumptions we can make as we pass this, and then because of the imprecise—or I think you may have said it—we find that come that magic date, we have missed because growth was lower or so on, I think Congress is going to have an opportunity at that time to address the sequestering order by us passing a resolution, as opposed to the GAO automatic order.

Now why should we, at that time, then sequester from that some 20 percent of the budget, which is education, law and justice, and the investment accounts of this country, after we have done the job of making the tough decisions to get to the $144 billion and then missed? I mean, does that really make sense?

Mr. VOLCKER. If you missed, for instance, because the economy was lower, I don't think you haven't done your job. And if the economy is lower, it disturbs me that the economy is lower, but the budgetary impact of that alone does not disturb me.

Mr. LOWRY. So, perhaps at that time we should look at—does it really make sense to sequester, since we did do our job?

Mr. VOLCKER. If you do your job in the first place; yes.

Mr. LOWRY. Right; using honest assumptions at this time.

Mr. VOLCKER. Right.

Mr. LOWRY. Thank you. I hope—I mean, if that becomes necessary, I hope we will address it logically.

The selling of assets question as deficit reduction—for instance, the power marketing institutes, I think, may be the biggest proposed selling of assets. I'm not sure that's true.

But is that real deficit reduction as the type that you're trying to encourage this Congress to move forward in accomplishing, to sell the Bonneville Power Administration?

Mr. VOLCKER. I think it obviously doesn't have the same effects on the credit markets, but that's a separate judgment in my mind. Is it a good idea to sell the Bonneville Power Administration on more general grounds?

I haven't got a position on that, but you might well arrive at that conclusion.

Mr. LOWRY. But as far as deficit reduction, is that deficit reduction, to sell that, aside from the question of whether it's a good or bad idea?

Mr. VOLCKER. It's deficit reduction as we define the deficit. It does not relieve the credit markets to the same extent.

Mr. LOWRY. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts, Mr. Atkins.

Mr. ATKINS. Thank you, Mr. Chairman.

Chairman Volcker, there has been considerable concern expressed, both from people in the administration, from Vice Chairman Preston Martin and from other economists, about the problem of so-called lag time between the time in which it will take Fed adjustments in monetary policy to affect the economy and the immediate effect of Gramm-Rudman cuts in the deficit.

In other words, cutting the deficit, cutting Federal spending will have an immediate effect on jobs and on economic output, whereas changes that you may make in monetary policy to adjust for those deficit reductions would take 6 to 9 months to have an impact, and in the interim period of time, there may be adverse consequences for our economic expansion.

Could you comment on whether that is a concern?

Mr. VOLCKER. The difficulty of economic policy is that there are long and variable lags in whatever you do, and they can't always be identified very accurately in advance. If you were living in a nice, theoretical textbook world, and you made some adjustment about what the effects of fiscal policy and monetary policy were, you might arrive at the decision that the time to do something is in April or something.

But there are many other things going on in the economy at the same time, as well as uncertainties about what happens to the budget, or to interest rates or other factors. Look at the enormous new influence we have had in the economy that I don't think anybody expected in the dimensions in which it has happened or in the timing in which it has happened from the oil price thing: A major favorable influence on prices, at the same time a release of real purchasing power to the American consumer that is going to come before your budget cutting efforts.

Now, you just can't forecast all those things. That is a dramatic development. On a smaller scale, things like that are going on all the time. So, I think one can appreciate the concern about this subject and the analysis of it, but I don't think we ought to kid ourselves that we have precise answers in a world in which all else doesn't stay equal. And there is uncertainty about the action itself.

Mr. ATKINS. But it would seem as though both the effects of the Gramm-Rudman cuts in the deficit and the lower oil prices would be, rather than cross currents, as you have referred to them, would be currents that are all moving in the same direction. And given the movement of those currents, one would presume that the Fed discount rate for short-term rates would be moving lower, yet in fact those rates, given the already impact on inflation rates and the lowering of the rate of inflation, are actually more burdensome relative to inflation now.

Mr. VOLCKER. I don't know. The inflation rate hasn't changed much just recently. Prospectively it may come down because of the oil price decline. But certainly the oil thing and the budget move in the same direction on the inflationary side. The oil thing also releases some purchasing power. Meanwhile, we have a big change in

the exchange rate, which has inflationary effects over a period of time, again with long and uncertain lags. So, that is another ingredient you have offsetting in the other direction.

Mr. ATKINS. Let me ask you if you have a view, and you have referred several times to the problem of essentially our addiction to foreign capital inflows and your thought that certainly we couldn't sustain the current trend line in those foreign capital inflows. Do you have a sense, first of all, of what is our current addiction to foreign capital inflows?

Mr. VOLCKER. With the size of our current account balance now, we have to rely upon foreign capital to the extent of something like $150 billion a year. Now, that money helps balance our internal accounts, too.

Mr. ATKINS. Should we have some policy similar to our deficit reduction policy to try and reduce that demand over——

Mr. VOLCKER. In a very fundamental sense, that deficit reduction policy is a policy to reduce that dependence. We are not so dependent upon the foreign capital as we reduce the budget deficit, and that is a major part of the point of the whole exercise, as I see it.

Mr. ATKINS. But there must be other actions that we need to take in addition to deficit reduction.

Mr. VOLCKER. The reduction in the value of the dollar, to the extent that improves the trade outlook, gives a complementary effect. That is what is so nice about what has been happening, in a conceptual sense. We get a better prospect for the trade balance and a better prospect for the budget balance, and both those things fit together in a complementary way and, among other things, reduce that dependence upon foreign capital.

Mr. ATKINS. And do you have a timeline as to when you think all that symmetry will get us to ground zero?

Mr. VOLCKER. It is going to have to extend, literally, over a period of years. You know, the budget deficit is going to be very high again this calendar year. The trade deficit isn't going to turn around on a dime, except for the direct effects of the oil price reductions. It is going to take a while for that to work, so you are talking about a process that is going to extend over 5 years.

The CHAIRMAN. The time of the gentleman has expired.

Before we invite to the witness table David Maxwell, the chairman and chief executive officer of the Federal National Mortgage Association, let us take this moment to thank Chairman Volcker for attending this hearing. Thank you, Chairman Volcker for your testimony. As always, you have been candid and to the point. We look forward to continuing to work with you.

Mr. VOLCKER. Thank you, Mr. Chairman.

The CHAIRMAN. The Chair now calls David Maxwell, chairman and chief executive officer of the Federal National Mortgage Association. Please come forward and testify upon the effects of the 1987 budget proposal on housing in this Nation and the housing market.

The House Budget Committee is continuing its Washington hearings on the potential impact of the President's 1987 budget. We have with us today David O. Maxwell, chairman and chief executive officer of the Federal National Mortgage Association, commonly known as Fannie Mae. Fannie Mae is a Government-sponsored

private corporation. Its purpose is to provide supplementary assistance to the secondary market for home mortgages.

In other words, Fannie Mae purchases mortgages from savings institutions and mortgage bankers and resells them on the secondary market. This results in a wider distribution of capital available for home mortgage financing.

The 1987 budget proposes to impose on all Government-sponsored enterprises a fee on new securities issues after September 30, 1986. According to the administration, this fee is for the purpose of reimbursing the Federal Government for the borrowing advantages these enterprises enjoy as a result of their special relationship with the Government.

This proposal appears to have a direct impact upon the housing market in the United States.

Therefore, we welcome to the Budget Committee Mr. Maxwell. We hope that his testimony will shed light on the impact of this policy proposed in the 1987 budget on housing markets across this Nation and the availability to the average home buyer in this Nation.

I want to thank you, Mr. Maxwell, for coming and sharing your views with the committee. We invite you to summarize your testimony. Your complete written testimony will be submitted for the record, and we look forward to your views.

We invite you to proceed, Mr. Maxwell.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE CORPORATION

Mr. MAXWELL. Thank you, Mr. Chairman and members of the committee.

As the chairman said, Fannie Mae is a private corporation whose sole purpose is to develop and support a national secondary market for residential mortgages.

Last year we provided mortgage financing for approximately 900,000 families, with the average mortgage amount being about $50,000. In 1982, when the housing market was reeling from high mortgage rates, Fannie Mae bought one of every seven mortgages originated in the country. Many lenders and builders said we were the only game in town.

As the head of Fannie Mae, I am grateful for the opportunity to emphatically state my opposition to the housing proposals in the administration's fiscal year 1987 budget. This budget sounds the retreat for this Nation's commitment to provide adequate housing for low-, moderate- and middle-income people.

We therefore strongly oppose the misnamed and misguided proposals to gut the FHA and VA housing programs and to ultimately destroy the usefulness of Fannie Mae, Freddie Mac and the Federal home loan banks by taxing away their ability to raise capital for housing.

The first thing to remember is that this budget is an ideological statement, not an economic document. In many places, the budget tries to impose an ideological point of view using the huge deficits

of the last 5 years as an excuse. Nowhere is that more apparent than in housing.

Housing is a vital part of the economy, accounting for 8 percent of the gross national product. As such, housing affects the size of the deficit. When housing is doing well, as it is today, more people are employed, more wages earned, more profits made and more taxes paid. These taxes help to lower the deficit.

Housing is doing well in significant part because of the supports that are now in place: FHA, VA, HUD programs, Ginnie Mae, Fannie Mae, Freddie Mac and the Federal home loan banks. If we cripple these supports, particularly those that do not cost the Government a penny, like Fannie Mae, housing will not do as well and the deficit will increase.

This triumph of ideology over economic reasoning is identified in a recent study by Chase Econometrics of just one of the administration's proposals. The study said, "OMB's proposed user fees for the federally sponsored agencies would have significantly negative consequences for the financial position of Fannie Mae, housing activity, the U.S. economy and the Federal deficit." I will discuss that study a little more later.

Let me summarize the major points in this statement. These budget proposals are not seriously aimed at deficit reduction; they are however, seriously aimed at removing the Federal Government's support for housing for low-, moderate- and middle-income people, regardless of whether or not that support costs the taxpayers a penny. In nearly every case, these supports for housing have not contributed to the current deficit.

Second, these proposals would double the upfront closing costs home buyers would have to pay if they obtain an FHA or VA mortgage. This would make it impossible for many working American families, particularly first-time home buyers, to purchase their own homes. May I invite your attention to chart 1, which shows that with the FHA and VA budget proposals the total cash required at closing would nearly double.

Third, for the first time ever, a $40,000 cap would be imposed on family income to determine eligibility for an FHA loan. The program would be limited to principal residences only. The income cap would have cut off one-third of those home buyers using FHA in 1985, according to an analysis by the Mortgage Bankers Association of America.

Fourth, HUD's budget for low-income housing assistance would be cut even further, indeed practically to the point of disappearance. From 1980 to 1986, the budget authority for housing at the Department of Housing and Urban Development was reduced by over 60 percent.

No one argues that housing programs should not take their fair share of cuts, but the proposals in the fiscal year 1987 budget when added to the previous cuts would amount to an 85-percent reduction in HUD's budget authority. That is not fair reduction. It is elimination of virtually all Federal housing assistance for our urban and rural poor and our elderly citizens as need for adequate housing grows more pressing every year.

I think members of the committee are familiar with the waiting lists in our cities for public housing, and certainly, from the discus-

sion this morning with the condition of the farm economy and with the help that the section 202 program has given to elderly citizens.

Fifth, the OMB proposed again this year a housing tax on Government-sponsored secondary market enterprises, a tax that would hit especially hard at Fannie Mae. This proposal would seriously cripple our ability to serve home buyers as we have done year in and year out since Congress made us a private company in 1970.

I invite the committee's attention to chart 2, which shows that an average VA loan of $63,300 with the new VA housing tax, then with the VA mortgage put into a Ginnie Mae pool and the Ginnie Mae tax applied, and then finally if the VA mortgage were sold to Fannie Mae and the Fannie Mae housing tax would be applied to it.

You can see that with the VA housing tax only, the increased cost to the home buyer would be about $5,800 over the life of the mortgage; with the VA and Ginnie Mae housing tax, $8,300 over the life of the mortage; and with the VA and Fannie Mae housing tax, $14,400 over the life of the mortgage.

Many said that last year's more modest proposal for user fees was just a foot in the door and that OMB would soon move to raise the fees. In this year's retreaded OMB proposal, these seers have been proven emphatically right. The fiscal year 1987 proposed fees are 5 to 10 times higher than last year.

Last year this committee and its chairman stood staunchly against these housing taxes and the proposal was rejected. If you had not done so, many American families would be paying more for their mortgages today. That was a great service to the people, and I urge you to repeat it this year.

There are at least five reasons why the user fee on Fannie Mae should be rejected. They are, first, the user fee is not a user fee at all. It is an excise tax on Fannie Mae's borrowing. User fees are charges to recoup taxpayers' outlays for services. Taxpayers do not support Fannie Mae. Fannie Mae does not spend Federal taxes, it pays Federal taxes.

Second, the Government sold Fannie Mae to private shareholders for $216 million. These shareholders provide the capital for the company. In 1981 and 1982, they absorbed $300 million of losses that the company had at that time.

To use the failures of Federal fiscal policy as a pretext to impose an added tax on them would be unconscionable.

Third, the Government continues to restrict Fannie Mae to a single business, providing a secondary market for residential mortgages for low-, moderate-, and middle-income home buyers, and we can only do this business because we can tap the capital markets. To tax our ability to borrow, while continuing to mandate and restrict the company's business, would be unfair and ultimately could be ruinous.

Fourth, the user fee is not deficit reduction. Revenues from any such tax that Fannie Mae could afford to pay would not make a dent in the deficit. This proposal is described as deficit reduction to mask an ideological assault on national housing policy.

And fifth, Chase Econometrics has estimated that this proposal would have significant negative effect on Fannie Mae and the hous-

ing market. Lawrence Chimerine, chairman and chief economist of Chase Econometrics, has stated:

> In each of the economic scenarios used to analyze the impact on the economy of the fees of Fannie Mae and other agencies, we found that their successful imposition will raise mortgage rates, reducing housing starts and sales, reduce jobs, and increase the deficit.
>
> In addition, and of major concern to me, these fees are being proposed against a rather disconcerting background for the U.S. financial system. The magnitude and timing of the proposed fees may very well serve to exacerbate the fragility of the financial markets in the current environment.

A copy of the Chase Econometrics study is included with my statement, and I would request permission to submit it for the record, Mr. Chairman.

The CHAIRMAN. Without objection.

Mr. MAXWELL. The third chart that you see is a summary of the findings of the Chase Econometrics study. In the period from 1988 to 1992, assuming declining interest rates and moderate growth, Chase estimates that with these user fees applied on Fannie Mae, there would be 163,000 fewer housing starts, 320,000 fewer housing sales, 320,000 fewer construction jobs, and 710,000 fewer total jobs and an increase in the deficit of about $17 billion-plus, of course, higher mortgage interest rates.

If, in fact, we are not so fortunate in the economy in the next 5 years and interest rates should rise in 1988 and 1989, the impact on Fannie Mae's financial condition would be such that Chase Econometrics estimates that we would have to halt our mortgage purchases in 1989, and the absence of Fannie Mae from the market could reduce housing starts by 75,000 units and sales by 100,000 units.

And I think Mr. Chimerine's reference to the fragility of the financial system would recall to the members the farm credit situation. To put Fannie Mae in this kind of situation might require the same kind of Government action.

And, of course, once again, the deficit would rise, not decrease, as a result of this.

The housing and mortgage finance industries represented by the Mortgage Bankers Association of America, the National Association of Home Builders, the National Association of Realtors, and the National Council of Savings Institutions are united in opposing these proposals. In doing so, these groups have gone on record for their respective industries, but they speak as well for millions of would-be home buyers for whom the dream of homeownership will become impossible if these proposals are enacted, and this committee can help to keep that dream alive by rejecting these proposals.

Thank you again, Mr. Chairman, for the opportunity to appear, and I would be pleased to answer any questions.

[Testimony resumes on p. 859.]

[The prepared statement of Mr. Maxwell follows:]

PREPARED STATEMENT OF DAVID O. MAXWELL

Mr. Chairman and Members of the Committee:

My name is David O. Maxwell, and I am Chairman of the Board and Chief Executive Officer of Fannie Mae. Fannie Mae is a private corporation whose sole purpose is to develop and support a national secondary market for residential mortgages. Last year, we provided mortgage financing for approximately 900,000 families, with the average mortgage amount being $50,000. In 1982, when the housing market was reeling from high mortgage rates, Fannie Mae bought one of every seven mortgages originated in the country. Many lenders and builders said we were "the only game in town."

As the head of Fannie Mae, I am grateful for the opportunity to emphatically state my opposition to the housing proposals in the FY 1987 budget. This budget sounds the retreat for this nation's commitment to providing adequate housing for low-, moderate-, and middle-income people. We, therefore, strongly oppose the misnamed and misguided proposals to gut the FHA and VA housing programs and to ultimately destroy the usefulness of Fannie Mae, Freddie Mac and the Federal Home Loan Banks by "taxing" away their ability to raise capital for housing.

The first thing to remember is that this budget is an ideological statement, not an economic document. In many places, the budget

tries to impose an ideological point of view, using the huge deficits of the last five years as an excuse. Nowhere is that more apparent than in housing.

Housing is a vital part of the economy, accounting for 8 percent of the gross national product. As such, housing affects the size of the deficit. When housing is doing well, as it is today, more people are employed, more wages earned, more profits made, and more taxes paid. These taxes help to lower the deficit.

Housing is doing well in significant part because of the supports that are now in place--FHA, VA, HUD programs, GNMA, Fannie Mae, Freddie Mac and the Federal Home Loan Banks. If we cripple these supports--particularly those that do not cost the government a penny, like Fannie Mae--housing will not do as well, and the deficit will increase.

This triumph of ideology over economic reasoning is identified in a recent study by Chase Econometrics of just one of the Administration's proposals. The study said: "OMB's proposed user fees for the federally sponsored agencies would have significantly negative consequences for the financial position of Fannie Mae, housing activity, the U.S. economy and the federal deficit." I will discuss this study more fully later in my statement.

Let me summarize the major points in this statement.

- These proposals are not seriously aimed at deficit reduction. They are seriously aimed at removing the federal government's support for housing for low-, moderate-, and middle-income people, regardless of whether or not that support costs the taxpayers a penny. In nearly every case, in fact, these supports for housing have not contributed to the current deficit.

- These proposals would double the up-front closing costs home buyers would have to pay if they obtain an FHA or VA mortgage. This would make it impossible for many working American families, particularly first-time buyers, to purchase their own homes.

- For the first time ever, a cap would be imposed on family income ($40,000) to determine eligibility for an FHA loan, and the program would be limited to principal residences only. The income cap would have cut out one-third of those home buyers using FHA in 1985, according to an analysis by the Mortgage Bankers Association of America.

- HUD's budget for low-income housing assistance would be cut even further--indeed practically to the point of disappearance. From 1980 to 1986, the budget authority for housing at the Department of Housing and Urban Development

was reduced by over 60 percent. No one argues that housing programs should not take their fair share of cuts, but the proposals in the FY 1987 budget, when added to the previous cuts, would amount to an 85 percent reduction in HUD's budget authority. That is not fair reduction. It is elimination of virtually all federal assistance for our urban and rural poor whose need for adequate housing grows more pressing every year.

- The OMB proposed again this year a "housing tax" on government-sponsored secondary market enterprises, a tax that would hit especially hard at Fannie Mae. This proposal would seriously cripple our ability to serve home buyers as we have done year-in and year-out since Congress made us a private company in 1970.

The Role of Fannie Mae in the Housing Markets

Before discussing each of the FY 87 budget proposals in some detail, let me first provide a summary to the Committee of what Fannie Mae is and what it does.

Fannie Mae was created in 1938 as a subsidiary of the Reconstruction Finance Corporation to purchase mortgages insured by the just-formed Federal Housing Administration (FHA). In 1949, we also began purchasing VA mortgages. In 1954, Fannie Mae was restructured as a mixed-ownership (part government, part private)

corporation to develop and support a national secondary market for residential mortgages.

Fannie Mae became a wholly privately owned corporation in 1968 after we paid the government $216 million for its interest. Our stock is listed and actively traded on the New York Stock Exchange. We remain supervised in many respects by the Secretaries of Housing and Urban Development, and Treasury. Five members of Fannie Mae's eighteen-person board of directors are appointed annually by the President of the United States; the others are elected by our approximately 30,000 stockholders.

Congress created Fannie Mae for one purpose: to provide assistance, liquidity, and stability to the residential mortgage market. The corporation operates entirely in the secondary mortgage market. We purchase mortgages from housing lenders, such as mortgage bankers, savings and loan associations, and commercial and savings banks, to resupply them with funds to lend people to buy homes and to build and rehabilitate rental properties. Fannie Mae obtains the money to purchase mortgages largely through borrowing in the capital markets.

Fannie Mae is the largest portfolio investor in mortgages in the United States, holding approximately $95 billion worth of mortgages at the end of 1985. We also issue and guarantee mortgage-backed securities (MBS), with $55 billion in MBS now

outstanding. Together, Fannie Mae's portfolio and MBS finance about one out of every ten mortgages in the United States.

Proposed Restrictions on FHA and VA

FHA and VA served 500,000 home buyers in 1985. The average size of an FHA mortgage in 1985 was $58,155 and for VA, $63,264. The Administration's budget proposals would limit these two programs in a way that is clearly inconsistent with current congressional policy.

First, the Administration proposes an income cap of $40,000 to determine eligibility for FHA insurance. If this proposal had been in place in 1985, one third of those families using FHA insurance would have been shut out. In Pennsylvania, the figure would have been 46 percent; in Ohio, 31 percent; in Texas, 44 percent; in Washington, 27 percent; and, in New York, 38 percent. Every congressional district in the country would be affected by this and the other housing proposals, and we have prepared that analysis for each Member.

Second, the Administration would double the cash outlay required at closing for FHA loans by increasing the up-front insurance or guarantee fees and by requiring that the FHA fee be paid in cash. The FHA insurance premium would rise from 3.8 percent to 5 percent. The first chart shows that the cash required for an average FHA-financed home would rise from $3,989 to $8,055, a 102

percent increase. The VA guarantee fee would rise from 1 percent to 3.8 percent, but could still be financed. If the entire increase is paid for up-front, the cash outlay for the average VA-guaranteed home would increase from $2,193 to $4,698.

Nowhere is it more clear that ideology triumphs over economics in this budget than in the FHA proposals. There is no financial justification for the FHA fee increases. The major FHA single-family mortgage insurance program had earnings of $161 million just last year. This increase in FHA's fees will inevitably increase the deficit because it will cause housing starts to decline, as well as employment in construction and related industries.

Cuts in the HUD Budget for Low-Income Americans

Ideology has also had a profound effect on HUD's budget. I want to register my strong concern about the additional cuts the Administration has proposed in HUD's programs to help house low-income families.

From 1980 to 1986, the HUD budget authority for housing programs for these citizens fell by more than 60 percent. The Administration's 1987 proposals for HUD would reduce the 1986 levels by an additional two-thirds, virtually shutting down the department's programs. None of us are arguing that housing should

not take its fair share of cuts. However, we believe that housing has already sustained more than its fair share.

These cuts have a very real effect. For instance, the Administration has proposed zeroing out the section 202 direct loan program for the elderly. This program has enjoyed consistent support from the Congress because it works and works well. There is still a crying need for modest, safe housing for our elderly citizens, the fastest-growing demographic group in the country. If there is a less expensive way to house these people adequately, fine; let's try and find it. But let's not eliminate funding altogether. The government has a responsibility to help our elderly citizens who have given this country so much. Modest, affordable shelter is one of their most critical needs. Perhaps Father Donald Sakano of New York City's Catholic Charities put it best when he stated: "One runs out of adjectives horrible enough to describe what this will mean for low-income and elderly housing."

Equally critical is assuring that rural housing is constructed or rehabilitated. The Farmers Home Administration now operates that program. The budget proposes to transfer that authority to HUD, but not increase HUD's funding to provide for it. That is just not right. Shoddy, unhealthy shelter is not limited to metropolitan areas. In fact, right now assistance for rural housing is more needed than ever.

In our cities, waiting lists for public housing grow ever more lengthy. Existing public housing facilities deteriorate. Surveys have shown inadequate housing to be one of the most severe problems facing our urban poor.

Surely, in all these areas -- for the elderly poor, the urban poor, the rural poor -- our country is rich enough and compassionate enough not to abandon all aid.

Housing Taxes on Secondary Market Entities

The Administration's budget isn't limited to entities that are part of the budget. It proposes a special "tax" on private firms. Let me elaborate.

The mortgage finance market is made up of two distinct types of institutions--primary market mortgage lenders and secondary market investors and guarantors. Fannie Mae, Freddie Mac and GNMA are restricted to operating in the secondary mortgage market.

Primary market lenders include mortgage bankers, savings and loan associations, savings banks, credit unions and commercial banks. These institutions lend directly to home buyers. Many of these lenders sell a substantial amount of the loans they originate to other companies in what is known as the secondary mortgage market. Fannie Mae has been operating in the secondary mortgage market

since 1938. GNMA and Freddie Mac started business in 1968 and 1970, respectively.

Fannie Mae provided $45 billion in mortgage financing last year. We anticipate a similar level of support in 1986. Looking at the entire market, $175 billion in mortgages were sold in the secondary market in 1985, out of a total $235 billion in originations, or 74.5 percent. The secondary market is crucial to increasing the supply of affordable funds for home buyers.

Under the Administration's FY 1987 budget, Fannie Mae would pay a so-called "user fee"--more accurately denominated a housing tax--to the Treasury each year on the company's borrowings and mortgage-backed securities (MBS). The fees would be phased in over three years, ultimately resulting in a full fifty basis points (1/2 of 1 percent) charge on all debt and ten basis points on all MBS. Based on OMB's figures, this fee would impose additional costs on Fannie Mae of more than $1 billion in the first five years alone. The other government-sponsored enterprises (Freddie Mac, Federal Home Loan Banks, Sallie Mae and Farm Credit) would also face these fees, but at varying rates.

The second chart shows the effect of these fees on the monthly mortgage costs of home buyers. Take the example of the average VA loan ($63,264) in 1985 with a mortgage rate of 10.5 percent; the monthly payment for principal and interest is $579. If the higher up-front VA fee is enacted and the borrower finances it,

the monthly payment goes up to $595. If we can pass on the 50 basis point housing tax, add another $24 to the monthly payment. The total increased monthly payment is $40, or $480 annually. Over the life of the loan, that converts to $14,400. This does not buy any more house or enable the borrower to pay off his or her loan more quickly; it is a housing tax, plain and simple.

Many said that last year's more modest proposal for "user fees" was just a foot in the door and that OMB would soon move to raise the fees. In this year's retreaded OMB proposal, these seers have been proved emphatically right. The FY 1987 proposed fees are five to ten times higher than last year.

Last year, this Committee and its Chairman stood staunchly against these housing taxes, and the proposal was rejected. If you had not done so, many American families would be paying more for their mortgages today. That was a great service to the people. I urge you to repeat it this year.

There are at least five reasons why this "user fee" proposal should be rejected. They are:

1) This "user fee" is not a user fee at all; it is an excise tax on Fannie Mae's borrowing. User fees are proper charges to recoup taxpayers' outlays for services. Taxpayers do not support Fannie Mae. Fannie Mae does not spend federal taxes;

it pays them. The company has been a victim, not a maker, of the federal budget deficit.

2) The government sold Fannie Mae to its private shareholders in 1970 for $216 million. Today, these 30,000 shareholders provide the capital base for the company; in 1981 and 1982, they--not the taxpayers--bore losses of $300 million. To use the failures of federal fiscal policy as a pretext to impose an added tax on them would be unconscionable.

3) The government continues to restrict Fannie Mae to a single business--providng a secondary market for residential mortgages for low-, moderate-, and middle-income home buyers. Only Fannie Mae's ability to tap the private capital markets for large sums at reasonable rates enables it to survive as a private company with but one government-mandated business. To tax this borrowing ability while continuing to mandate and restrict the company's business would be unfair and ultimately ruinous.

4) Chase Econometrics has estimated that this proposal would have a significant effect on Fannie Mae and the housing markets. I will explain that in more detail in a minute.

5) This "user fee" is not deficit reduction. Revenues from any such tax Fannie Mae could afford to pay would not make a dent in the deficit. This proposal is described as deficit

reduction to evade careful consideration of such a radical change in national housing policy by the Senate and House Banking Committees.

To gain an objective view of this proposal, we commissioned Chase Econometrics to analyze and measure the effects.

Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics, stated: "In each of the economic scenarios used to analyze the impact on the economy of the fees on Fannie Mae and other agencies, we found that their successful imposition will raise mortgage rates, reduce housing starts and sales, reduce jobs and increase the deficit. In addition, and of major concern to me, these fees are being proposed against a rather disconcerting background for the U.S. financial system. The magnitude and timing of the proposed fees may very well serve to exacerbate the fragility of the financial markets in the current environment."

A copy of the Chase Econometrics study is included with my statement, and I would like to submit it for the record. Let me highlight the following findings of the study which also appear in the third chart.

In a scenario with modest economic growth and secularly declining interest rates over the period 1988 to 1992, Chase Econometrics concludes there will be:

- 163,000 fewer housing starts, with 50,000 less starts in 1992 alone;

- 320,000 fewer housing sales, with 89,000 less sales in 1992 alone;

- 320,000 fewer construction jobs and 710,000 fewer total jobs;

- $17 billion increase in the deficit; and,

- higher mortgage interest rates.

Chase Econometrics then assumed that interest rates would rise in 1988 and stay high through 1989. The effects over the same time period are:

- Fannie Mae's financial condition will worsen immediately; Fannie Mae loses $300 million in 1989 and must stop buying mortgages in the middle of that year;

- the absence of Fannie Mae from the market will reduce housing starts by 75,000 units and sales by 100,000 units in 1989 alone, and mortgage commitment rates will rise by 50 basis points;

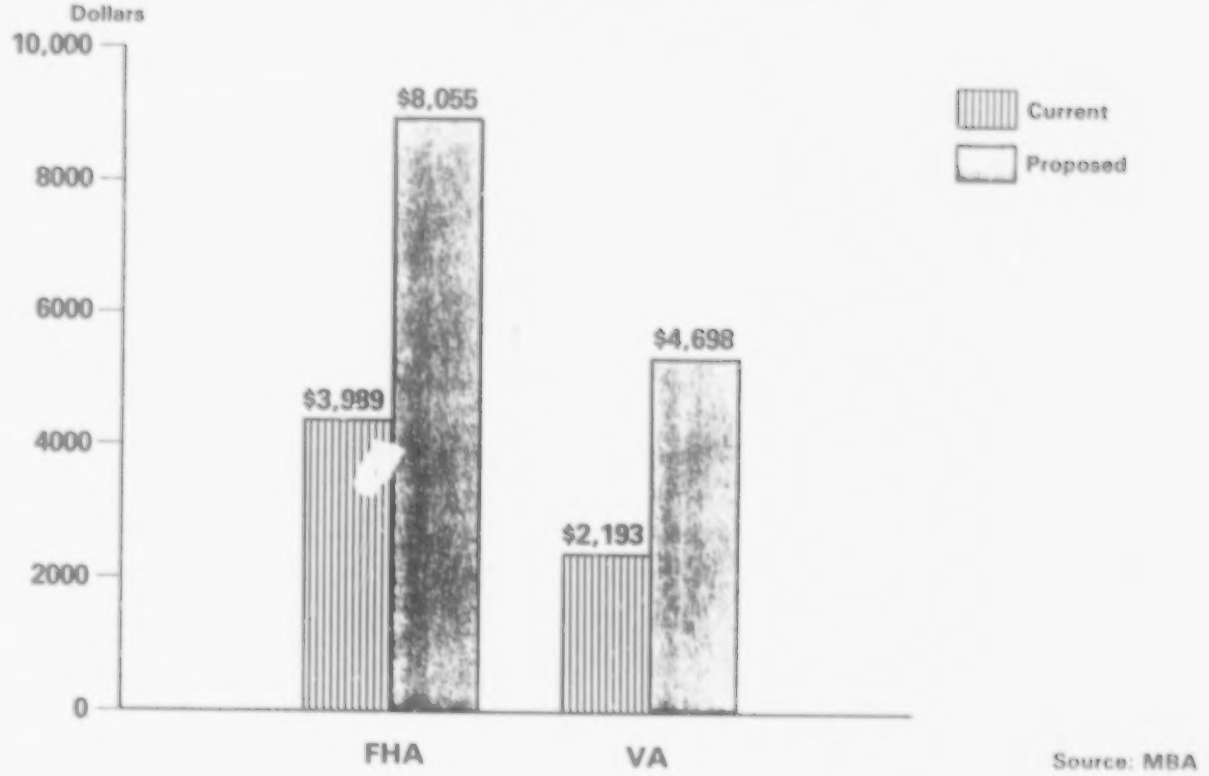
- the government would have to devise and implement a rescue plan for Fannie Mae; and,

- the deficit would rise significantly.

The housing and mortgage finance industries --represented by the Mortgage Bankers Association of America, the National Association of Home Builders, the National Association of REALTORS®, and the National Council of Savings Institutions--are united in opposing these proposals. In doing so, these groups have gone on record for their respective industries. They speak as well for millions of would-be home buyers, for whom the dream of homeownership will become impossible if these proposals are enacted. This Committee can help keep that dream alive by rejecting these proposals.

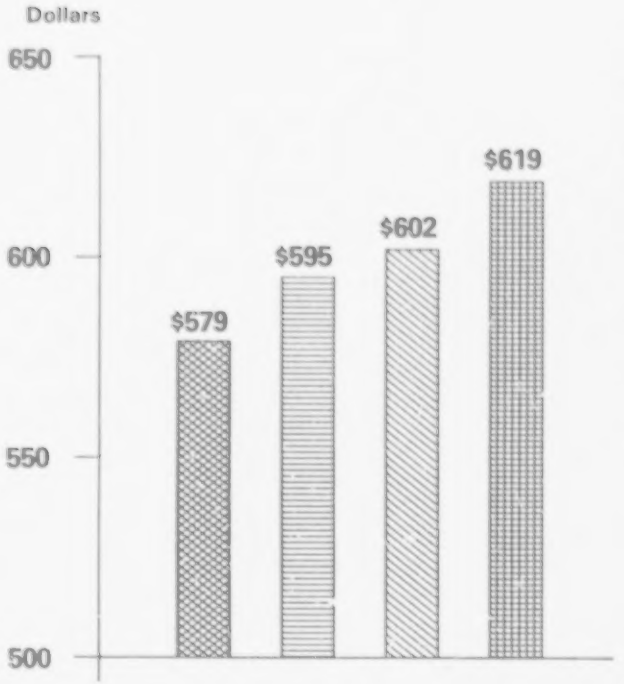
Thank you. I will be pleased to answer any questions you may have.

EFFECT OF FY1987 BUDGET PROPOSALS ON FHA/VA BORROWERS
TOTAL CASH REQUIRED AT CLOSING



Source: MBA

HOUSING TAXES RAISE MONTHLY MORTGAGE PAYMENTS



- Current average VA loan ($63,264)
- With new VA Housing Tax (3.8%)
- With VA and GNMA Housing Taxes
- With VA and Fannie Mae Housing Taxes

Results:

Housing Taxes cost homebuyer:

1. With VA Housing Tax only - $5,760 over life of mortgage
2. With VA and GNMA Housing Taxes - $8,280 over life of mortgage
3. With VA and Fannie Mae Housing Taxes - $14,400 over life of mortgage

Sources: MBA and Fannie Mae

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CHASE ECONOMETRICS REPORT
FINANCIAL AND ECONOMIC EFFECTS OF USER FEES 1988-1992

Declining Interest Rates

- 163,000 fewer housing starts; 50,000 in 1992 alone
- 320,000 fewer housing sales; 89,000 in 1992 alone
- 320,000 fewer construction jobs and 710,000 fewer total jobs
- Increase in deficit of $17 billion
- Higher mortgage interest rates

Rising Interest Rates

- Fannie Mae's financial condition worsens immediately
  - Loses $300 million in 1989
  - Midway through 1989 must halt mortgage purchases
- Absence of Fannie Mae reduces housing starts by 75,000 units and sales by 100,000 units in 1989
  - Mortgage commitment rates rise by 50 basis points
- Government would have to rescue Fannie Mae
- Deficit rises significantly

A Report To

The Federal National Mortgage Association

Financial and Economic Impacts of the Proposed Imposition of User Fees on FNMA and Other Federally Sponsored Agencies

February 1986

FINANCIAL AND ECONOMIC IMPACTS OF THE PROPOSED IMPOSITION OF USER FEES ON FNMA AND OTHER FEDERALLY SPONSORED AGENCIES

a report to

The Federal National Mortgage Association
Washington, DC

by

Chase Econometrics
Bala Cynwyd, Pennsylvania 19005

February 11, 1986

This report was prepared by Chase Econometrics, Inc. for the Federal National Mortgage Association under the direction of Roger C. Lister, Director of Financial Industry Services at Chase Econometrics. The opinions expressed herein are those of the authors and not necessarily those of the Federal National Mortgage Association.

EXECUTIVE SUMMARY

OMB's proposed user fees for the federally sponsored agencies would have significantly negative consequences for the financial position of FNMA, housing activity, the U.S. economy, and the federal deficit. The proposed fees would apply to FNMA, GNMA, FHLMC, FHLBs, and the other federally sponsored agencies based on their taxable debt and mortgage-backed securities. For FNMA, in particular, the proposed fees are large relative to its source of income, particularly the 50 basis points fee on taxable debt. The user fees FNMA would have to pay would be a significant proportion of its net income. The relative magnitude of the proposed fees would force FNMA's management to alter its present policies to cope with the negative impact of the proposed fees on FNMA.

At the request of FNMA, Chase Econometrics analyzed and measured the implications of the proposed user fees. Two alternative policies through which FNMA can cope with the fees were investigated. Either FNMA can attempt to pass on the fee, or it can reduce the maturity of its debt to offset the cost of the fee by funding shorter. To analyze the impacts of each policy, they were evaluated in two very different economic scenarios: a basecase scenario of moderate long-term growth and secularly declining interest rates, and a high interest rate scenario, where rapid growth in the economy generates rapidly rising interest rates.

The main findings of this study are:

In the base case with moderate long-term growth in the economy, if FNMA can successfully pass on the user fees, the negative effects on the economy include:

- 163,000 fewer housing starts in the period 1988-1992, including 50,000 fewer starts in 1992 alone;
- 320,000 fewer housing sales in the same five year period, including 89,000 fewer sales in 1992;
- 320,000 fewer construction jobs and 710,000 fewer total jobs including 170,000 fewer total jobs in 1992;
- Lost output in real terms of $24 billion; this leads to an increase—not a decrease—in the deficit in nominal terms of $17 billion, which is only partly offset by user fees collected.
- Higher mortgage interest rates.

In the high interest rate case, if FNMA can successfully pass on the full 50 basis points user fee, the relative impacts are slightly larger than in the base case.

In the high interest rate case, if FNMA cannot pass on the fee, and must borrow shorter to absorb the added cost, the effects are potentially disastrous:

- FNMA's financial condition would worsen immediately, causing FNMA to lose $300 million in 1989;
- Midway through 1989, FNMA would have to halt its purchase of mortgages;

- The absence of FNMA from the mortgage market would reduce housing starts by 75,000 units in 1989 alone and home sales by 100,000 units in the same year; mortgage commitment rates would rise by over 50 basis points;

- The government would have to rescue FNMA, as it did recently with the Farm Credit System; and,

- The effects on the federal deficit would be significantly negative.

In summary, successful imposition of these user fees will raise mortgage rates, reduce housing starts and sales, reduce jobs and increase the deficit. In the high rate case, FNMA's very future could be threatened if it couldn't pass on the fees, and had to fund shorter to absorb the higher costs.

The financial markets are likely to view the proposed fees as having a negative impact on FNMA and the other agencies. While some may view the fees as solidifying the implicit federal guarantee of the agencies, this assessment goes against the announced intention of the proposed fees. The expressed intention of the proposed fees is to reduce the involvement of the federal government in the activities these agencies are engaged in. In fact, the proposed fees imply a reduction in support for the agencies and their involvement in the development of secondary-mortgage markets and the stabilization of housing finance. The future viability of the agencies, particularly FNMA, are therefore threatened by the proposed fees.

These fees are being proposed against a rather disconcerting background for the U.S. financial system. Mortgage insurance (MI) companies have experienced significant losses over the last several years, and those losses show little chance of dissipating soon. Mortgage foreclosures and other real estate loan problems plague many lenders, including FNMA. The EPIC debacle this past summer clearly illustrates both these problems. The U.S. Congress may also be forced to appropriate a significant amount of money to bolster the resources of the FSLIC, or consider merging the FSLIC with the FDIC fund. This problem will only get worse if rates rise. Bankruptcies of commercial banks are at an all-time high since the Depression. Finally, the Congress just rescued the Farm Credit System--another government-sponsored enterprise similar to FNMA. Instead of reducing the federal government's involvement in financial activity, the magnitude and timing of the proposed fees may very well serve to exacerbate the fragility of the financial markets in the current enviroment.

I. THE PROPOSED USER FEES

OMB is proposing to impose user fees on the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Home Loan Bank System (FHLBS), and the other Federally sponsored agencies, as well as the Government National Mortgage Association (GNMA). These user fees take two forms: a fee on debt issued and a fee on the mortgage-backed securities issued and guaranteed by FNMA and FHLMC, and those guaranteed by GNMA. The fees differ both by being higher for debt than MBS and by being applied differently across the agencies.

FNMA faces the stiffest set of user fees. The fee it would have to pay on taxable debt issued rises to 50 basis points by fiscal year 1989. Taxable debt issued is defined as follows:

- any increase above the level of FNMA debt securities outstanding on September 30, 1986, plus
- the lesser of:
  - FNMA debt issued prior to FY 1987 rolling over in FY 1987 and beyond, or
  - repayments and prepayments on mortgages purchased prior to FY 1987.

The fee schedule is:

FY 1987	10 basis points
FY 1988	30 basis points
FY 1989	50 basis points

For mortgage-backed securites issued after September 1986, the fee schedule is:

FY 1987	5 basis points
FY 1988	10 basis points

The user fees for the other agencies differ in certain important respects. FHLMC faces the same fee that rises to 10 basis points on its issues of MBS, but different fees on its taxable debt. For the purposes of this fee, FHLMC's CMOs are considered to be MBS rather than debt. Its fee on taxable debt rises to only 12.5 basis points, giving it a competitive advantage over FNMA in its acquisition of mortgages for its portfolio. The FHLBs taxable debt fee goes to 12.5 basis points also. The fee on GNMA's MBS would rise from its present level of 6 basis points to 20 basis points.

These proposed fees are not one time fees to be paid when the taxable debt or MBS is issued, but rather are to be paid annually based upon the rules described above.

II. HOW THE PROPOSED USER FEES WILL AFFECT FNMA

The user fees are large relative to FNMA's sources of income. Currently, commitment fee income is the largest source of income for FNMA, generating 21 basis points relative to its debt outstanding (see Table 1). FNMA's net interest margin on its portfolio has been negative for the past four years, turning positive only in the second quarter of 1985. Thus, the user fee of 50 basis points on taxable debt would have a significant impact on FNMA's net income under FNMA's present pricing policies.

FNMA's SOURCES OF INCOME
(PERCENT)
TABLE 1

	1985	1984	1983	1982	1981
Int. Income/Mortgages	10.52	10.48	10.48	9.78	9.25
Int. Exp./Debt	10.57	10.63	10.71	10.53	10.24
Portfolio Spread at year end	0.04	-0.58	-0.45	-1.30	-1.57
Commitment Fees/Mortgages	0.21	0.14	0.20	0.38	0.19
MBS Fees/MBS	0.20	0.22	0.22	0.11	0.05
Fee Income/Debt	0.33	0.23	0.28	0.40	0.19
MBS Fees/Debt	0.12	0.09	0.07	0.02	.00
Commitment Fees/Debt	0.21	0.14	0.20	0.38	0.19

FNMA's Income

Fannie Mae's income comes from three main sources: (1) net interest income; (2) fee and other income; and (3) mortgage sales. These are discussed in turn.

(1) Net interest income has been negative in recent years, becoming positive again only very recently. Net interest income is the difference between FNMA's yield on its mortgage portfolio and the cost of its outstanding debt. While the difference (or spread) between the mortgages purchased in a given year and the debt issued in that same year has been positive since the fourth quarter of 1981, the difference (or gap) between FNMA's yield on its outstanding portfolio and its outstanding debt has, until 1985's second quarter, been negative, at times sharply so. This is because FNMA's portfolio is laden with low coupon, low prepayment mortgages that FNMA acquired in the 1970s, while its funding activities have been conducted for the most part in a period of high and volatile interest rates. The very high interest rate levels of the early 1980s aggravated this "mismatch" between assets and liabilities by forcing FNMA to issue shorter term debt than would normally be prudent in order to avoid locking in high cost debt of a long maturity. While the lower interest rate environment of the last year has ameliorated this condition somewhat, FNMA's mismatch leaves it vulnerable to increases in the level of interest rates. In order to correct this problem, FNMA has been purchasing greater volumes of adjustable rate mortgages, which provides FNMA with greater protection when interest rates rise. Somewhat offsetting this protection, however, is the lower yield of ARMs along with their greater risk of default. FNMA has also moved aggressively to lengthen the maturity of its debt by issuing longer term debt over the past year, tapping both domestic and foreign markets. This process has meant sacrificing current income for better protection against upward movements in interest rates.

(2) Fee income is derived from two main sources: commitment fees and mortgage backed securities guaranty fees.

Commitment fees are charged to mortgage originators who purchase commitments that either allow or require them to deliver their product to FNMA, usually within a few months. The commitment fee rate varies as to the type of product purchased (fixed or adjustable rate mortgages), its age, the conditions of the commitment's deliverability (optional or mandatory), the time period for which the commitment is issued and the mortgage coupon rate. Commitment fee income is sensitive to the volume of commitments issued and also to competitive activities on the part of

other secondary mortgage firms, particularly FHLMC. In the first three months of 1985, FNMA's commitment fees have averaged 0.75 percent of total commitments. In 1984 total commitment fee income was $114 million, or 64 percent of total fee income. That percentage has fallen dramatically in recent years as the volume of commitments has leveled off and, perhaps more importantly, as the volume of mortgage-backed security guaranty activity has increased.

MBS guaranty fees are derived from FNMA's Mortgage-Backed Securities program. In this program, lenders exchange their mortgage directly for FNMA securities and then either retain the securities in portfolio or sell them. In the MBS program, FNMA enables a lender to swap pools of mortgages for FNMA MBS. FNMA charges the lender for its guarantee of timely payment to the investor of interest and principal on the MBS through the spread between the pool's mortgage rate and the security's interest rate. FNMA's standard fee (or spread) for this guaranty is 25 basis points, if the lender assumes all the risk of any defaults on mortgages in the pool. The fee is 30 basis points, if FNMA assumes all the risk of default on the pool's mortgages. Recently, competitive market conditions and economies of scale have led to lower average fees of about 17 to 22 basis points. Guaranty fee income has increased in recent years along with the rise in the volume of MBS issued. In 1984, guaranty fee income increased 44 percent to $78.1 million or 34 percent of all fee income.

Other income totaled $35.4 million in 1984.

Because FNMA's interest margin has been negative since 1981 and only became positive in 1985's second quarter (see below), fee income has constituted the bulk of FNMA's net income. Even in a decidely favorable interest rate environment such as 1985's third quarter, where net interest income reached a positive $49.6 million, fee and other income totaled $92.0 million, or almost twice interest income.

(3) FNMA periodically sells mortgages, sometimes realizing a gain on these sales. While this practice has at times contributed substantially to net income (FNMA realized gains of $90.7 million from the sale of mortgages in 1983) it lowers the average yield on FNMA's portfolio, since the mortgages being sold typically offer higher yields than those currently available.

III. THE CONTRIBUTION OF FNMA AND THE OTHER AGENCIES TO HOUSING FINANCE

Before considering the options open to FNMA and the other agencies, we need to discuss the contribution that these agencies make to the mortgage markets, particulary the secondary mortgage markets.

The Development of the Secondary Mortgage Markets

Home buyers obtain mortgages from originators of mortgages: thrift institutions, (savings and loans, federal savings banks and mutual savings banks), mortgage bankers, and commercial banks. Many of these mortgages are then sold on the secondary market either as whole loans or to form pools to back mortgage-backed securities. Although whole loan sales continue to be important, loan sales to form pools now constitute about half of the secondary mortgage market. As a result, MBS issues have grown rapidly, especially during the past five years. Loans in mortgage pools now comprise about 25 percent of all home mortgages outstanding, up from less than 15 percent in 1981. From the perspective of the home buyer, this change has meant a greater availability of funds, but a closer tie between rates on mortgages and the generally prevailing interest rates in the capital markets.

In carrying out their charter goals, the federal housing agencies have had much to do with the development of the secondary market for mortgages. FNMA was chartered in 1938 as a part of the government to contribute to this development by buying FHA/VA mortgages from originators and issuing debt. This enabled originators in areas where funds were in short-supply at prevailing rates to originate loans, which could then be sold to FNMA, permitting the originator to make new loans. FNMA was also able to ameliorate the impact of the business cycle on housing activity by increasing its purchases of mortgages when there was a shortage of funds for housing finance. FNMA became completely privately-owned in 1970, but remained limited to the mortgage business under its charter.

A major development was introduced in 1970 when GNMA began guaranteeing securities backed by pools of FHA/VA mortgages. These securities passed through the monthly interest and principal payments from the mortgage pool to investors based on the investors' pro rata shares in the underlying pool. GNMA had been created in 1968 to take over certain functions from FNMA and to administer government mortgage subsidy programs. GNMA's MBS was a valuable innovation that enabled investors to buy liquid, marketable and guaranteed mortgage-related investments, rather than investing directly in mortgages.

The secondary mortgage markets developed quickly in the 1970's due to the active participation of the federal housing agencies. FHLMC was created in 1970 as another secondary mortgage market participant. By offering portfolio investors a vehicle for acquiring mortgage related assets, these programs allowed investors to take advantage of the spread between yields on mortgages and yields on government bonds. Both programs were successful in attracting funds for housing finance. FNMA and FHLMC contributed to this process by standardizing the documentation and underwriting of mortgages. The expanding volume of MBS outstanding increased their liquidity, as markets developed for these securities. Their success owed much to the guarantee provided by the federal status of GNMA and the federal agency status of FHLMC. Not until 1977 were any private nongovernment MBS issued. Although more of these private MBS have been issued since 1977, the volume has been small relative to the agencies. MBS issued by private conduits amounted to about 2 percent of total MBS outstanding in 1983. Marketability and economies of scale are key factors in the predominance of the federally related MBS.

The most recent development in the secondary mortgage markets has been the introduction of "swaps." A swap occurs when a lender exchanges mortgages in its portfolio for MBS backed by the pool. The key to the success of the swap programs introduced by FNMA and FHLMC was that a swap permits a lender to turn below market mortgages into more liquid below market MBS without incurring capital losses on the exchange. A ruling that swaps would count as an exchange of like assets permitted lenders to restructure their portfolios without having to book the large capital losses that a sale of the mortgages would have produced. The major users of the swap program were S&Ls. They used the program to acquire liquid MBS that could be lent out under repurchase agreements to provide a source of funds. They also were able to sell their newly acquired MBS when rates fell. Even in the current lower-rate environment, swaps continue to be popular as a vehicle for maintaining the liquidity of S&Ls' portfolio of mortgage-related assets and as a vehicle for originating and selling mortgages.

The Contribution of the Agencies to Housing Finance

Our analysis of the agencies' activities during the past five years shows that they contribute to stabilizing the flow of funds and the cost of funds for housing. Their contribution comes from three sources. First, they offer commitments to mortgage originators to buy mortgages at a specific rate, thereby reducing the interest rate risk exposure of the originator and the risk that funds will not be available. Second, they provide funds for housing finance directly by purchasing loans for portfolio, or in the case of the FHLBs, providing funds to S&Ls

who can purchase more loans for their portfolios. By standing ready to buy mortgages whatever the conditions in the general capital markets, they ensure that originators of mortgages have an outlet for their mortgages at all stages of the business cycle. Third, they provide instruments for the sale of pools of mortgages by providing the conduit through which mortgages can be converted into securities and guaranteeing the MBS backed by these pools.

By providing a marketplace for newly originated loans, the agencies enable lenders to make commitments to borrowers that allowed the borrowers to enter into contracts to buy homes. These commitments are obtained at given rates that permit the lender in turn to commit to a given rate to the home buyer. In the case of new homes, it is often the builder who obtains the commitments from lenders in order to provide the mortgage funds to the purchasers of the homes that the builder plans to construct. Without the commitment for the funds, the builder faces the risk that interest rates will rise and buyers will be unable or unwilling to buy the newly built houses at the higher rates.

Commitments are also important, because they ensure that funds are available to match the loans being originated so that loans can be moved quickly from origination to sale. In the past, this contribution of the commitment process was important, because deposit flows were often inadequate to support the volume of home financing required when rates were rising. Now that deposit rates are no longer controlled by Regulation Q, this shortage of funds problem will be less important overall. The commitment process, however, continues to be important as a means of ensuring the smooth flow of funds to originators. This process is especially important for mortgage bankers, who do not hold loans in portfolio. Any disruption in the process of moving mortgages along from origination to sale means that mortgage bankers incur the high cost of warehousing the loans. For builders, any disruption in the flow of funds to buyers of newly built homes means incurring the costs of financing an increased inventory of unsold homes.

The second contribution towards stabilizing the flow of funds to housing comes from the agencies' ability to provide funds for homebuying directly. FNMA, and to a lesser degree FHLMC, have acquired mortgages for portfolio, financing these purchases by raising funds from the capital markets. The FHLBs provide funds by lending to their member institutions, who in turn lend to home buyers. The agency status of these entities enables them to borrow at rates that are generally below the rates that the primary mortgage lenders, such as S&Ls, face in periods of high interest rates. Our analysis demonstrates that these injections of funds have contributed to keeping mortgage rates lower than they would otherwise have been. Their contribution is measured by the share of funds these agencies have been providing. These agencies have acted countercyclically by contributing more in periods of relatively high interest rates than they have in periods of relatively low interest rates.

As with the commitment process, the existence of these agencies ensures that the originators of mortgages know that these agencies stand ready to buy mortgages at given prices, regardless of the general availability of funds for housing finance. FNMA is particularly important in this process for mortgage bankers. Because FNMA is always an active participant in the secondary mortgage market, mortgage bankers can rely on FNMA to purchase their newly originated mortgages, even when other channels for selling mortgages are cut off. Purchases of mortgages from mortgage bankers have dominated FNMA's portfolio acquisitions in periods when funds for housing were constrained. The loss of FNMA as the buyer of last resort for mortgage bankers would impose a significant increase in the risks mortgage bankers face in making funds available to home buyers.

FHLMC has provided far less funds through acquisitions for its portfolio. Most of the loans it acquires are used to back its issues of pass-through certificates. Until recently, it also charged a higher fee to sellers who were not members of the FHLBS. Even so, FHLMC, like

FNMA, is available as a buyer of last resort. The FHLBs are important in ensuring the availability of funds by providing S&Ls with a reliable source of funds. S&Ls can rely on the FHLBs to provide funds at a cost that is to some degree insulated from the general level of interest rates and from the current state of S&Ls balance sheets. Loans from the FHLBs in the form of advances have enabled S&Ls to continue to make mortgage loans during periods when the flow of funds via deposits was restricted by high interst rates and S&Ls low earnings.

The third contribution of the agencies is the conduit activity that enables pools of mortgages to be converted into securites that are attractive to investors. The various MBS guaranteed by GNMA, FHLMC and FNMA are acceptable investments for many portfolio investors who would not purchase mortgages directly. By comparison to a pool of mortgages, a portfolio of MBS is more diversified, more liquid and marketable, subject to less interest rate risk, and less expensive to manage. Innovations such as CMOs have further enhanced the attractiveness of MBS to investors by dividing up the prepayment risk between investors in the same pool.

MBS have found a growing market over the past five years as the spread between mortgage rates and alternative investments such as Treasury bonds widened from the levels of the mid-1970s. The additional funds coming from the capital markets have certainly contributed to increased housing activity. The MBS of GNMA, FHLMC and FNMA combined accounted for 28 percent of mortgage originations in 1984 up from 15 percent in 1979 (when FNMA was not yet issuing MBS). The proportion rose to 55 percent in 1982, as thrifts actively engaged in swaps during a year when originations were only half their present level. The subsequent decline in the ratio to a more normal level in 1984 reflects the much slower volume of swaps, as thrifts have successfully restructured their portfolios of mortgage-related assets. This expanding source of funds has helped to maintain housing activity during the high interest rate period of the past five years. Tapping the capital markets has provided funds during a period when thrifts, the primary mortgage lenders, were sometimes experiencing deposit outflows and generally had weak earnings. Through mortgage backed securities investors were abie to take advantage of the high mortgage rates without incurring the costs or risks of purchasing the mortgages directly.

The major drawback to the growing proportion of funds coming from MBS is that investors face different constraints from thrifts, the traditional mortgage lenders. Thrifts invest most of their funds in mortgages or mortgage-related assets. Investors, such as insurance companies, pension funds, etc., choose their investments to maximize the return on their portfolios subject to certain criteria. While these criteria will vary with the characteristics of the investor, almost all of them will hold much more diversified portfolios than thrifts. As a result, increasing the proportion of MBS in investors portfolios typically will occur only if yields on MBS have widened over yields on other investments.

Mortgage backed securities embody certain unique risk characteristics that differentiate them from other securities such as bonds. Investors thus are likely to limit the proportion of MBS held in their portfolios to diversify the overall risks to which their portfolios are exposed. All MBS embody the five forms of investment risk: credit risk, market risk, liquidity rick, reinvestment risk and prepayment risk. With respect to the first three risks, MBS have become more comparable to other securities over the past five years, at least for the MBS of FNMA, FHLMC and GNMA. In the case of the last two forms of risk, however, predicting the pace and timing of the capital repayments of the underlying pool is difficult, which significantly increases these forms of risk to an investor holding MBS. In comparison to a bondholder, who knows both the size and the timing of interest and capital payments, the MBS-holder faces the task of predicting how fast the mortgages in the underlying pool will be repaid. Simply calculating the yields on MBS requires making forecasts of the pattern of prepayments. Past prepayment patterns are not necessarily a guide to future prepayment patterns. In addition, the

costs of incorrectly predicting interest rates, and hence, prepayment rates are much worse for the MBS-holder than the bondholder, because prepayments are negatively correlated with interest rates. If rates rise, the MBS-holder receives less in repayments to invest at the higher rates. If rates fall, the MBS-holder receives more in repayments, but these funds must be invested at lower rates. One recent innovation, CMOs, was introduced as a means to reduce the reinvestment and prepayment risks of MBS for investors. The unique characteristics of MBS, however, continue to pose additional risks to the investor for which an additonal margin is required. Thus, if the proportion of MBS increases significantly, the spread between mortgage rates and bond rates will widen, as investors seek higher yields on MBS to offset the risks of holding a greater proportion of their portfolio in MBS.

IV. FNMA'S POLICY OPTIONS AND THE FINANCIAL MARKETS

FNMA has two primary policy options to pursue in the face of the size and consequent implications for its financial prospects of the proposed user fees:

1. FNMA can attempt to pass on the fees in full by raising its own commitment rate and MBS fees to match the fees. Under this option, FNMA's business would decline and it would pay less in user fees over time.

2. If FNMA is unable to pass on the proposed fees, FNMA can choose to reduce the cost of its debt to match the fees by shortening the maturity of the debt it issues. Under this option, FNMA would have to pay more in user fees, and face the higher risks of this policy of funding shorter.

As part of this project, we have analyzed the likely outcomes of these two alternative policy options. In so doing, we have explored the range of impacts that are likely to occur under each policy option. In this section, we discuss how the proposed fees would alter FNMA's present policies and how the financial markets will assess the impact of the fees on FNMA's financial prospects.

Assessing the implications of the fees from the perspective of the financial markets is complicated by the uncertainty surrounding the fees. At present, the financial markets view the debt of the federally sponsored agencies as carrying an implicit guarantee. Because the guarantee is implicit, some risk remains that the condition of any single FSA might deteriorate to such a degree that it would be unable to rollover its maturing debt. In such an event, the holders of the debt would experience losses, even if they eventually were able to collect both interest and principal.

The likelihood that actual capital losses might be sustained by holders of FSA debt remains remote. In view of the federal government's history of stepping in to rescue any large private-sector institution that does experience serious financial difficulty, the financial markets generally expect similar policies to be followed in the future. However, serious financial problems have led to sharp increases in the spread between the rates on new debt and Treasuries for FNMA in 1981 and the Farm Credit System in 1985. Any new policies that alter the financial prospects of an FSA will affect the financial markets perception of the riskiness of their debt

In the absence of any explicit guarantee, the financial markets must evaluate any changes in federal government policies to determine their impacts on the financial prospects of the individual FCAs. One feature of this assessment must be to evaluate the prospects for any disruption in the FSA's payment of interest and principal, and the likelihood of even the unlikely occurrence of capital losses. While the recent rescue of the FCS has confirmed the federal government's general policies, the successful imposition of the user fees can also be taken to

mean a shift in the other direction, away from support for the agencies. The announced purpose of the proposed fees is to reduce the competitive advantage that federal sponsorship confers on the agencies. The intention is to reduce the level of involvement of the agencies and increase the likelihood that they can be completely privatized. The proposed fees are not being introduced to make the implicit guarantee explicit. The financial markets may take the successful imposition of the fees to indicate that the FSAs are even more likely to obtain assistance now that they are paying fees. This view, however, runs counter to the intentions of the present proposal.

While the outcome cannot be determined in advance, two factors make it likely that the outcome will be to increase the rates that the FSAs have to pay on their debt. First, the uncertainty surrounding the prospects of the FSAs upon successful imposition of the fees is likely to lead to a small additional risk premium, particularly for longer term maturities. The successful imposition of the fees has negatve implications for the long-term prospects of the FSAs. The proposed fees are not accompanied by any proposed liberalization of the federal charters of the FSAs. These charters significantly restrict both the activites the FCAs are permitted to engage in and how they undertake these activites. Second, the impact of the fees on the financial positions of the FSAs will change the likelihood that any particular FSA could experience financial difficulties.

For FNMA, the fees mean a substantial reduction in its net income. As part of this project, we made projections of the fees that FNMA would pay under our Base Case Scenario, assuming it was unable to pass on the user fees. Over the five years from 1988 to 1992, we estimate that FNMA would pay about $2.0 billion in fees. This level of fees represents a significant proportion, as much as half, of the income FNMA could be expected to earn over this five year period. In essence, if FNMA ends up absorbing the user fees, not only will it be exposed to more interest rate risk from funding shorter, but it will also face a significant reduction in its expected net income.

In assessing the impact of the fees on FNMA's financial position, the financial markets will be concerned both by the magnitude of the fees and the added riskiness they may impose on FNMA. The negative impact of the fees is made more important because FNMA has only recently experienced an improvement in its earnings after a period of weak earnings. The sheer magnitude of the fees, as well as their timing, means they cannot be ignored by the financial markets. How much the imposititon of the fees would actually raise the rates FNMA has to pay on its debt still depends upon the markets perception of the strength and speed of support offered by the implicit guarantee

The impacts on the other agencies will be much smaller because the fees on their taxable debt will be much lower than that on FNMA. Accordingly, the impact of the fees will fall disproportionately on FNMA.

In response to its mismatch between the duration of its assets and liabilities, FNMA has adopted new policies. It has moved to increase the interest sensitivity of its assets through the acquisition of adjustable rate mortgages (ARMs) and second mortgages. As part of its ongoing support for housing finance, FNMA instituted a new program to purchase second mortgages. By setting underwritting standards and offering to buy conforming second mortgages, FNMA took an important step towards developing a national market in second mortgages. Home sellers who had provided financing during the high-rate, creative financing period of the early 1980s now face much improved opportunities to sell their second mortgages to FNMA or other lenders who adopted FNMAs standards. FNMA also moved to lengthen the maturity of its debt, sacrificing current income to fund with longer maturity debt raised both in U.S. and foreign capital markets.

The sheer magnitude of the proposed fees will force changes in FNMA's policies. One option open to FNMA is to attempt to pass on the user fee on taxable debt by raising FNMA's commitment rate and pass on the user fee on MBS by raising its own MBS fees. This option transmits the fees through to the mortgage markets directly. Such a choice will have negative impacts on housing and the economy. We discuss this option in two scenarios: Scenario I, our base case forecast for the economy, and Scenario II, a scenario that has rising interest rates.

A second, and riskier option that FNMA may have to take is to lower the maturity on its newly issued debt to offset the cost of the user fees. Such a policy runs counter to FNMA's present policies, which are appropriate for a financial institution with FNMA's present asset/liability structure. This policy also runs counter to the directives that are being given to FNMA by HUD and the recommendations currently being made by the GAO. We explore the implications of this strategy in Scenario III. In the scenario, the choice of sliding down the yield curve results in FNMA being very adversely affected by the combination of rising interest rates and the escalating impact of the fees on its income. By 1989, FNMA experiences major losses, and is largely forced to withdraw from purchasing mortgages. The impacts in 1989 upon housing and the economy are significantly worse in this case.

V. BASE CASE FORECAST

Our evaluation of the impact of the user fees on the economy and the federal budget begins with our base case scenario. In a non-linear world, shifts in the housing market will have different impacts depending upon the state of the economy and whether it is near a trough or a peak in housing activity. Given our current outlook, which is discussed below, the imposition of the user fees would not shift the path of the economy from our base case scenario of 2 to 4 percent average growth over the forecast horizon. The imposition of the user fees, however, would impair FNMA's financial position and visibly reduce the levels of single-family starts and existing home sales.

The present Chase Econometrics baseline forecast used in the simulation experiments described below is based on a continued modest rate of growth in 1986, in the range of 2.5 percent accelerating modestly in 1987 but remaining in a growth range of 2.5 to 3.5 percent for much of the rest of the decade of the 1980s and into the early 1990s. Our evaluation suggests that the economy is likely to continue to be held back by the extremely high real interest rates and overvalued dollar of recent years. While both have been coming down, they remain too high to permit much more rapid growth. As a result, we expect interest sensitive sectors, especially housing, inventories, and capital spending, to remain fairly sluggish during 1986. The trade deficit is unlikely to show any significant improvement in 1986, although it should not continue to worsen because the decline in the dollar has not yet been sufficient to alter U.S. competitiveness significantly. In addition, banks are becoming increasingly cautious as a result of rising loan delinquencies and losses, and are thus tightening lending standards in many sectors. Further declines in interest rates and the dollar are necessary to stimulate more rapid growth in part because other fundamentals remain relatively weak. These include the rate of increase in personal income, the rate of increase in profits, the slack in housing markets and the general environment for investment including extremely low utilization rates in the industrial sector and high vacancy rates for commercial, office and industrial structures.

Nonetheless, we continue to believe that while the fundamentals are not overly strong, an outright recession in 1986 will be avoided and indeed by the second half, declining oil prices, generally low inflation and lower interest rates combined with a weaker dollar will support a higher level of activity.

The outlook for 1987 and the years beyond for the U.S. economy depends crucially on prospects for (1) fiscal policy, (2) further declines in oil prices, (3) the path for interest rates and (4) the outlook for the U.S. dollar and its implications for trade and inflation.

Perhaps the greatest imponderable in the present outlook in the U.S. is in the area of fiscal policy. As indicated below, fundamental influences suggest that the rate of growth in the U.S. economy might very well accelerate modestly from the near 2 1/2 percent level in 1986 to something above 3 percent in 1987 and 1988 if the fiscal stance prior to passage of the Gramm-Rudman- Hollings Bill had remained in force. Our analysis suggests that if Gramm-Rudman were fully implemented, growth would remain below 2 percent for both 1987 and 1988 and the dangers of a full blown recession become quite significant in the latter period. Our present baseline forecasts is based on the premise that the full impact of the Gramm-Rudman Hollings Bill is not applied to the U.S. economy. We presently assume that deficit reduction measures are put in place throughout the second half of the eighties and that they cumulatively will depress growth particularly in 1987 and 1988 by something on average approaching approximately 0.5 percent. This reduction in growth prospects is what results in an average growth rate for 1987 and 1988 of approximately 2.8 percent. The second major area of uncertainty in view of developments during the most recent period is in the area of oil prices. Our baseline forecast assumes that oil prices will remain reasonably stable in nominal terms through 1988. Beyond this period, prices are expected to begin to rise at roughly the rate of inflation, with real price increases being deferred until the early 1990s.

Perhaps the most relevant issue with respect to growth prospects for the alternative simulations is the general outlook for interest rates. It is our general view that real interest rates can be expected to average something higher than the rates experienced in the 1960s and 1970s for the rest of this decade and into the early 1990s. Real rates are likely to be supported by the additional risks financial intermediaries must bear as a result of deregulation of financial markets but are presently at a premium as a result of a variety of factors, including the balance sheet position of financial intermediaries, the financing burden of the Federal sector deficit and the general level of uncertainty regarding the evolution of the cyclical position of the U.S. and world economies. The prospective reduction in real rates beyond 1986 is likely to occur despite some increases in nominal rates as inflation begins to rise somewhat in the 1988-1990 period. The differential between inflation and loan rates is likely to narrow somewhat on a general basis during this period resulting in modest reductions in real interest rates calculated on this basis.

In particular, the real mortgage rate facing home buyers will be higher than in the 1960s and 1970s. Mortgage rates now are much more closely linked to movements in interest rates than in the past. Two significant changes in housing finance have contributed to these closer links. First, the imbalance between average yields on mortgage portfolios at depository institutions and the cost of deposits in the early 1980s has resulted in mortgage rates at depository institutions being tied more closely to general interest rates. Second, the proportion of funds being made available for housing finance from the private nondepository capital markets has increased. In the future, changes in long-term rates will feed much more quickly into the mortgage rate offered to home buyers. As long as real rates generally remain high, mortgage borrowers will face high real rates. Housing activity thus will remain at lower levels than in the 1960s and 1970s.

The final issue regards the behavior of the U.S. dollar and its implications for trade during the second half of the decade of the 1980s and into the early 1990s. Our general view is that the trade weighted dollar is likely to decline by another ten percent by the end of 1986, after which gradual declines are likely to occur at least through the end of the decade. This decline sets the stage for improvements in both the real and nominal balances as we move into the latter part of the 1980s and the early 1990s with the trade sector acting as a support for expansion and adding something on the order of 0.5 percent per year to real growth.

In this environment the U.S. economy is expected to expand at an average rate of approximately 2.8 percent for the period from 1988 through 1991. This baseline forecast thus has the U.S. growing at close to its trend rate for the period beyond 1988.

VI. IMPACT SCENARIO I: FNMA PASSES ON USER FEES

To evaluate the impact of FNMA's option to pass on the proposed user fees, we have made two key assumptions.

- All the other FSHAs pass on their user fees in the same manner;
- No changes are made in monetary or fiscal policy.

Given the nature of these markets, some portion of the user fee would be passed on through increased mortgage rates to home buyers. The deterioration in the housing market, lower economic growth, etc. could be offset by either easier monetary or easier fiscal policy. In either case, one would anticipate that the final result for the economy with policy offsets could be a return to the same real growth and employment levels, but at higher inflation rates, as in the classic excise tax case where activity impacts can be offset by macro policy with a new equilibrium at a higher inflation level. We have assumed in this scenario that there are no such offsetting changes in macroeconomic policies.

1. The First Round Effects: Mortgage Rates Rise

The impact of the user fees feeds through to mortgage rates viavarious channels. FNMA's increase in its commitment rate by the full amount of the fee results in a decline in FNMA's share of total commitments, and hence, the share of funds it is providing to the mortgage markets. The funds FNMA was supplying through its purchases must now come from other sources. In addition, the fee charged for MBS rises by 5 basis points.

While FHLMC faces a lower fee on its taxable debt than FNMA, the growth in FHLMC's holdings of mortages is constrained both by the user fee and by its capital base. While raising capital via equity is an option for FHLMC, we have assumed that FHLMC does not pursue this path, because its management, which is regulated by the Federal Home Loan Bank Board, feels constrained by the broad policy objectives implied by the fees.

The fees on the FHLBs reduces S&L borrowings via advances. We have assumed that S&Ls raise more funds via deposits to take advantage of the increased business they now experience, as originators seek alternative outlets for their mortgages in response to FNMA's higher commitment rate. Some of these additional funds, however, must go to replacing the decline in advances from the FHLBs. Given the interestrate environment in the base case, this expansion is feasible, but the continued weakness of thrift balance sheets generally constrains the extent of this expansion.

In combination, these lower levels of agency activity imply a shift in the sources of funds for housing finance. Much of the funds that would have come via increased holding of mortgages at the agencies must now come from issuing MBS.

It is this shift to MBS, along with the higher FNMA commitment rate, that generates the increase in mortgage rates. The general capital markets must now absorb a much higher level of MBS each year to generate the funds for housing finance. In order to induce investors to increase their holdings of MBS beyond what they would have acquired without the fee, the spread between the mortgage commitment rate and the Treasury bond rate must increase. Thus, lower cost agency debt is replaced by higher cost funds from the capital markets. The

fees are clearly structured to accomplish this shift, because the fee on debt is higher than the fee on MBS, particularly for FNMA.

While the rapid growth in MBS over the past few years has been accomodated by the financial markets, the shift to MBS implies that initially an increase of 2-3 percent in MBS must now be absorbed by the capital markets. Ultimately, the fee generates an increase of almost 15 percent in MBS issues. While S&Ls have been net acquirers of MBS, they are expected to reduce the proportion of MBS going into their portfolios to reflect the increased cost of swapping mortgages for MBS. By the end of 1987, the cost of swapping mortgages for MBS has increased by a third from 25 - 30 basis points to 35 - 40 basis points with the addition of the 10 basis point fee. If the average fee of 17 - 22 basis points is considered, the average cost of carrying out a swap rises by half. Such an increase in the fees reduces the volume of swaps by S&Ls, who choose to sacrifice some portfolio liquidity in return for holding more mortages in their portfolios.

In addition to these direct effects, there are secondary effects that reflect the higher costs to originators of obtaining commitments in the capital markets. These effects are incorporated into the model via the structural coefficients. Increased uncertainty about the availability and cost of funds contributes to raising the cost of mortgage funds.

The initial impact of the fees is to increase mortgage rates both because originators who continue to sell to FNMA, and to a lesser extent FHLMC, face higher agency commitment rates and because the volume of MBS is increasing, and investors require higher yields to hold the additional MBS. As the fees increase in 1988 to 30 basis points on FNMA's taxable debt and 10 basis points on MBS, mortgage rates increase again and further depress housing activity.

2. Second Round Impacts: Weaker Economic Activity

Higher mortgage rates feed directly into the economy by reducing housing starts. The primary impact falls on the construction of single-family homes, as the mortgage commitment rate rises (see Table 2 and 3). This downturn in housing activity reduces construction employment and other economic activity associated with the construction of single-family homes. This lower level of activity, in turn, reduces income and employment in the economy at large. By 1988, the combination of higher mortgage rates and weaker economic activity reduces single-family starts by 26,000 units. Construction employment is down 30,000 and employment in the economy is down 60,000.

By 1989, the user fees now are in full force. In FY 1988, the user fee on taxable debt increases to 50 basis points for FNMA and 12.5 basis points for FHLMC and the FHLBs. Some of the impact on mortgage rates, however, is mitigated by lower interest rates that are induced by the weaker economy. Even so, single-family starts are down by 24,000 (see Table 3). The weakness in the economy now leads to a visible decline in multi-family starts. While the fees do not increase further, the impact of the fees continues to be felt as the weakness in the economy feeds through into less demand for housing. Despite some decline in interest rates generally, not enough demand is generated elsewhere in the economy to offset the losses coming from reduced housing related activity.

By 1991, lower rates are stimulating some recovery in economic activity, but the effects of the fees continue to be felt in the housing sector. The volume of MBS issued is now 10 percent higher than in the base case.

By 1992, slightly higher rates and little recovery in the economy leave housing still down almost 50,000 starts below the base case forecast (see Table 3). At this point, construction

employment is down 80,000 and employment in the economy is down 170,000 from the base case.

Real output is down by $5 billion in 1982$.

3. Cumulative Impact of the Fees: 1988-1992

To assess the overall impact of the fees, we compiled the cumulative impact of the fees on the economy over the five years 1988-1992. This period begins with the full imposition of the fees on MBS and the increase in the fee on FNMA's taxable debt to the full 50 basis points. Taking the five years 1988-1992 together, the impacts on the economy presented in Table 3 accumulate to:

- 141,000 fewer single-family starts;
- 22,000 fewer multi-family starts;
- 320,000 fewer sales of existing homes;
- 320,000 fewer jobs in construction, and 710,000 fewer jobs nationwide;
- Lost output in real terms amounts to $24 billion in 1982 dollars.

The impact on the federal deficit is also negative. We have estimated that the fees on FNMA generate $ 1.6 billion over these five years under this scenario. The fees paid by the FHLBs are likely to amount to about $650 million. The fees paid by FHLMC on its debt are likely to amount to about $110 million. The fees paid on MBS issued by the other agencies are likely to amount to about $2.0 billion. In total, the fees from the other agencies are projected to generate revenues of about $2.8 billion. Total revenues from the fees add about $4.3 billion. Over these five years, however, the decline in economic activity would reduce tax revenues and increase the federal deficit by $17 billion, excluding the revenues from the fees. In sum, the impact on the federal government's budget over the five years 1988-1992 is:

- a cumulative increase in the deficit of $17 billion;
- less, the additional revenues from the fees of $4.4 billion.

The fees thus fail to offset the losses in revenues from the lower levels of economic activity that are induced by the impact of the fees on the mortgage markets and housing activity. Moreover, we have not adjusted the revenues generated by the fees for the lower income taxes paid by the agencies due to their increased expenses as they pay the fees.

VII. HIGH RATE FORECAST

Financial institutions that fund short and lend long are very vulnerable to a trend of rising interest rates, especially when this upward trend culminates in a period when short-term rates exceed long-term rates. The 1970s and 1980s were years when thrifts experienced several such episodes. The results were very damaging to housing activity and to the financial position of thrifts. These were also years when the activities of the agencies were important in providing support for the housing markets, both directly and indirectly.

Only in the past two years have thrifts' financial position seen an improvement from their weakened state in the early 1980s. As a result of these recent experiences, thrifts have moved to restructure their assset/liability positions to enable them to ride out such episodes in

the future. They have moved to make their assets more sensitive to interest rates by increasing the proportion of adjustable rate mortgages in their portfolios. They have also increased the proportion of liquid mortgage-related assets by purchasing MBS. Deregulation also gave thrifts new asset powers that have enabled them to diversify into new lending activities. They have rapidly expanded their consumer lending activities. In 1985, consumer loans at FSLIC-insured institutions increased by $14 billion to $44 billion, while mortgages increased by $52 billion to $651 billion. Commercial loans now account for $14 billion at these institutions. On the liability side, the virtual elimination of Regulation Q offers them an opportunity to lengthen their liabilities, although minimum early withdrawal penalties continue to inhibit this process.

FNMA also funded short and lent long. It too was caught in the vice, as rapidly rising interest rates overtook the more slowly adjusting yield on its assets. When the gap between its mortgage portfolio yield and its cost of funds was persistently negative, it experienced a period of financial difficulties, and the spread it paid over Treasury rates widened sharply in 1981. In response to these difficulties, FNMA's management instituted programs to provide a better match between the interest sensitivity of its assets and liabilities. FNMA acquired adjustable rate mortgages and second mortgages, and introduced new products to generate fee income through its MBS program. Unlike S&Ls, FNMA could not diversify into new lending activites because its charter restricts it to participating in mortgage-related activities.

Over the past year, the decline in interest rates enabled FNMA's management to lengthen the duration of FNMA's debt, tapping not only the domestic markets, but also foreign markets. This lengthening of debt maturities came with a cost, as rates on longer maturity debt exceeded those on shorter maturity debt. But, the cost was judged worthwhile to provide FNMA with better insulation against another episode of rapidly rising rates. Any reduction in FNMA's current income would constrain its ability to further lengthen the duration of its liabilities

It is not uncommon for the U.S. economy to experience rising interest rates followed by a period when short-term rates exceed long-term rates. Since 1970, there have been four periods when the yield curve in the Treasury market inverted over its entire term structure, with the 3-month T-bill rate moving above the rate on 20-year Treasury bonds. The longest of these periods, 1979-1980, lasted 18 months.

These yield curve inversions do not occur in isolation or by accident. Such an outcome is usually associated with a deliberate effort by the monetary authorities to reduce the rate of growth of money and credit. Typically, this action comes in response to an unacceptable acceleration in economy-wide inflation rates. The likelihood of yield curve inversion is closely tied to the appearance of unacceptable levels of inflation. While such a rebound in inflation appears distant with present low inflation levels and declining oil prices, many U.S. capital market participants currently are evaluating such a path for the economy. Their concern is that rapid growth in the economy could generate pressure on prices, acceleration in the rate of inflation and, ultimately, a sudden application of the brakes on the growth of money and credit.

A plausible scenario that would generate both an upward trend in interest rates and the resultant policy induced yield curve inversion can be easily sketched. The current low inflation rates and satisfactory oil and other commodity price developments produce a more growth-oriented policy package from U.S. monetary and fiscal authorities. Faster real growth domestically, aided by a trend decline in the exchange rate, generates inflation rates in the five percent range. The growth-oriented polices are not changed, because the policy authorities ascribe the upturn to temporary factors, such as exchange rate corrections. The runup in inflation is tolerated, and the gradual transfer of inflationary momentum to wage-setting behavior and to financial market expectations is overlooked.

The "temporary" upturn thus becomes structurally embedded in the economy. Companies and individuals seek more credit to take advantage of anticipated rising prices. In the process, the forces neccessary to regenerate inflation gather powerful momentum. Higher inflation and stronger economic growth are accompanied by rising interest rates, but the anticipation of accelerating inflation continues to drive the economy. House prices and the prices of other assets are rising rapidly in response to the demand for real assets.

The monetary authorities now discover that inflation is moving towards 7 percent or higher, rather than settling back to a 4 percent range. In reaction to accelerating inflation, the monetary authorities act to sharply slow the rate of growth of money and credit. Short-term interest rates rise rapidly, going above long-term rates, as the pressures of the expanding economy meet the newly imposed limits on credit growth.

This set of policy choices would follow the pattern of other business cycles over the past 15 years. Low inflation encourages pro-growth policies, which in turn accelerate key elements of demand. Rapid growth produces bottlenecks, or the opportunity to create such bottlenecks as in the case of oil markets, which generate upward pressure on prices.

Underlying our high rate scenario, which includes a period of yield curve inversion, are the following assumptions that generated higher inflation:

- a faster decline in the trade-weighted dollar;
- oil price stability rather than oil price declines
- faster growth in other countries;
- a more rapid pace of inventory build-up;
- an acceleration in hourly wages to a more typical mark-up over inflation.

The course of the economy and mortgage market activity over the next seven years is shown in **Table 5**. In this environment, the impact of the fees will be different from their impact in the Base Case. The agencies are relatively more important in supporting housing activity in this environment, as thrifts are still not fully protected from interest rate risks. Moreover, FNMA's option to fund shorter to offset the cost of the fees leads to serious financial problems both for FNMA and for the economy.

VIII. IMPACT SCENARIO II: FNMA PASSES ON USER FEES IN HIGH RATE CASE

We have assumed in this scenario that FNMA passes on the user fees by raising its commitment rate. This increase in FNMA's commitment fee feeds through to the mortgage markets and housing finance in the same manner as in Scenario I. FNMA provides less funds to the market at higher rates than without the user fees, and more funds have to come from private capital markets. The increased volume of MBS issues, along with FNMA's increased commitment rate and the higher fees for MBS, contribute to raising mortgage rates. Once again, we have assumed no offsetting changes in macroeconomic policy.

In 1987, the mortgage rate rises 10 basis points and single-family housing starts fall 17,000 (see **Tables 6 and 7**). The generally tighter conditions of the mortgage markets increase the initial impact of the imposition of the user fees over impacts found in Scenario I. This scenario has the imposition of the user fees occuring during a period of rapidly rising rates. In 1988, mortgage rates rise further, and single-family starts decline by 30,000. Weaker economic activity now is feeding through to multi-family starts, which decline 4,000. Construction

employment is down 50,000 from the High Rate Case and employment in the economy at large is down 110,000.

After the user fee on FNMA's taxable debt rises to 50 basis points in FY 1988, the mortgage rate in 1989 is up by 29 basis points. Single-family housing starts are down by 30,000 and multi-family starts are down by 5,000 units (see Table 7). The sharp decline in rates in 1990 significantly improves the economy's condition and mitigates, to some degree, the impacts of the user fees. With short-term rates heading down, more funds are generally available for housing finance, and the pressures induced by the imposition of the fees decline. Even so, the fees continue to keep mortgage rates up and reduce housing activity through 1992.

The relative impacts of the fee are larger in this scenario, than in Scenario I. The fees contribute to a decline in housing activity of 3.3 percent in 1989 and 2.4 percent in 1990. By comparison, the reductions are 2.0 percent in 1989 and 2.1 percent in 1990 in Scenario 1. The fees thus reduce the contribution the agencies make to stabilizing housing activity in this high rate scenario. As the economy recovers in this scenario, the relative impact of the fees also declines in 1991 and 1992.

To assess the overall impact of the fees, we again compiled the cumulative impact of the fees on the economy under this scenario over the five years 1988-1992. While the pattern of impacts differ over the cycle, the cumulative impacts of the fees are similar in this scenario to those founds in Scenario I. Taking the five years 1988-1992 together, the accumulated impacts on the economy as reported in Table 7 are:

- 133,000 fewer single-family starts;
- 28,000 fewer multi-family starts;
- 320,000 fewer sales of existing homes;
- 330,000 fewer jobs in construction, and 740,000 fewer jobs nationwide;
- Lost output in real terms amounts to $22 billion in 1982 dollars.

The impact on the federal deficit is also negative. We estimated that the fees on FNMA generate $1.6 billion over these five years. The accumulated total for the user fees paid by FNMA is virtually the same as in the base case, although the pattern of payments is somewhat different. Assuming the same level of revenues for the other agencies that was estimated in the base case, thus, gives total fees for the other agencies of $2.8 billion. The total revenues from the fees amount to $4.4 billion. Over the five years, 1988-1992, the impact on the federal governments budget is:

- a cumulative increase in the deficit of $18 billion;
- less, the additional revenues from the fees of $4.4 billion.

Thus the fees fail to offset the losses in revenues from lower levels of economic activity. Since we have not adjusted the revenues from the fees to account for lower income taxes paid by the agencies, the actual revenues generated by the fees will be even less than the estimates provided above.

IX. IMPACT SCENARIO III: FNMA FUNDS SHORTER IN HIGH RATE CASE

In this scenario, FNMA funds shorter to offset the costs of paying the fees. If FNMA cannot pass on the user fees, its only alternative is to fund shorter. In the base case, this option does not have any major negative impacts, because interest rates decline over the forecast horizon. In the high rate case, however, this policy ultimately leads to negative earnings for FNMA and the virtual halting of FNMA's commitments to purchase, as rising interest rates and the increasing burden of the user fees are compounded by FNMA's funding shorter. In sum, if the user fees require FNMA to repeat the same strategy as in the past, the results are likely to be equally negative for FNMA's financial position in this scenario. A major factor, however, in the downturn of FNMA's income is the escalating cost of the fees it must pay on its taxable debt.

The gains FNMA obtains by sliding down the yield curve to fund shorter result initially in lower costs of new funds for FNMA. Accordingly, the fees have no noticeable impact on the economy. This option continues to generate lower costs for FNMA's funds until rates begin to rise quickly, particularly in 1988. By 1988, the disadvantages of funding shorter are apparent, as FNMA's cost of funds begins to rise rapidly. At the same time that rates are rising, the impact of the fees on taxable debt are also being felt. FNMA is projected to pay $162 million in fees in 1988, with a significant increase in the fees from 30 to 50 basis points in the fourth quarter of 1988. The combination of rising rates, the increasing burden of the fees, and a small increase in the spread between FNMA's debt and Treasury yields drives FNMA's income negative in the fourth quarter of 1988.

The financial markets are alerted to the seriousness of both FNMA's asset/liability mismatch and the rapidly escalating burden of the fees. The financial markets incorporate the expected cost of the fees and the prospect of major losses into the risk premiums for FNMA debt. Accordingly, FNMA's cost of debt rises further, as its spread over Treasuries widens. The prospect of continued higher rates and major losses, in part generated by the fees, leads to further increases in the spread. In the absence of the fees, the financial markets would be more optimistic about FNMA's future financial condition. Lower rates could bring a lower cost of funds and improved earnings. The timing and magnitude of the fees, however, make a speedy recovery from negative earnings less likely. The annual user fee payments FNMA would have to make would still rise over 1990-1992, if FNMA remained in business. If the financial markets expect high rates to continue, FNMA's financial condition would indeed be seen as untenable. The markets would in effect limit the funds FNMA could raise. Midway through 1989, we project that FNMA would have to virtually halt its purchases of mortgages in response to the escalating cost of issuing new debt.

The impact on the economy would be immediate. We project that the absence of FNMA would reduce housing starts by 75,000 in 1989 alone (see Tables 8, 9, and 10). The impact on the economy would be much more significant than if the user fees were passed on. Our high rate scenario assumes that interest rates decline in 1990, but this decline is not anticipated by markets participants. How the federal government deals with the rapidly deteriorating condition of FNMA thus becomes important. If the federal government moves quickly to effect a rescue of FNMA, for example, by significantly increasing FNMA's line of credit with the Treasury or guaranteeing FNMA's debt, the impact on the economy will be limited to the temporary loss of FNMA's participation in the mortgage markets. In the absence of a speedy rescue and growing concern at the lack of action, FNMA's problems would be transmitted to the other agencies' cost of debt, and to the financial markets generally. Even in the case of the rescue of Continental Illinois, markets rates increased due to the uncertainty in the financial markets about how its difficulties would be handled. Presumably, some action would be taken, but the costs to the federal government will almost certainly far to exceed the revenues generated by the fees on FNMA's taxable debt.

In sum, the pattern of events resulting from this scenario demonstrate the very real risks of the proposed user fees. Under a familiar pattern of the economy and interest rates, the user fees ultimately lead to the serious impairment of FNMA's financial position and the virtual cessation of its mortgage purchases. The consequences for the financial markets, the economy and the federal budget deficit would be considerably worse in 1989, than in the base case forecast. What happens subsequently depends upon the policies the federal government introduces to cope with FNMA's problems.

X. CONCLUSIONS

OMB's proposed user fees for the federally sponsored agencies would have significantly negative consequences for the financial position of FNMA, housing activity, the U.S. economy, and the federal deficit. The proposed fees would apply to FNMA, GNMA, FHLMC, FHLBs, and the other federally sponsored agencies based on their taxable debt and mortgage-backed securities. For FNMA, in particular, the proposed fees are large relative to its source of income, particularly the 50 basis points fee on taxable debt. The user fees FNMA would have to pay would be a significant proportion of its net income. The relative magnitude of the proposed fees would force FNMA's management to alter its present policies to cope with the negative impact of the proposed fees on FNMA.

The financial markets are likely to view the proposed fees as having a negative impact on FNMA and the other agencies. While some may view the fees as solidifying the implicit federal guarantee of the agencies, this assessment goes against the announced intention of the proposed fees. The expressed intention of the proposed fees is to reduce the involvement of the federal government in the acitvities these agencies are engaged in. In fact, the proposed fees imply a reduction in support for the agencies and their involvement in the development of secondary-mortgage markets and the stabilization of housing finance. The future viability of the agencies, particularly FNMA, are therefore threatened by the proposed fees.

If FNMA raises its mortgage commitment rate and MBS fees in response to the user fees, mortgage rates would rise and housing activity and the economy would be adversely affected. Under our base-case forecast, FNMA purchases fewer mortgages and more funds have to be raised from the capital markets through increased issues of mortgage-backed securities. In combination with FNMA's higher commitment rate, this shifting of funds to MBS raises the mortgage rate, as investors demand a higher yield to increase their holdings of MBS. The rising level of the user fees increases their impact on the economy over time. Over the five years 1988-1992, the economy loses 163,000 housing starts, 320,000 existing home sales, and 710,000 jobs nationwide. The federal deficit increases by $17 billion, far exceeding the user fees paid by the agencies of $4.4 billion.

Under our high rate scenario, the impacts on the economy of FNMA passing on the user fees are broadly similar to the impacts found in Scenario I. The relative impacts, however, are greater at times because the agencies' activites are more important in the rising interest rate environment of this scenario. If FNMA is unable to pass on the proposed fees, its alternative policy is to fund shorter. This policy runs counter to the policies FNMA has adopted to reduce its interest rate risk exposure. In the high rate case, this policy ultimately leads to a much higher cost of funds. When combined with the escalating payments of user fees, this higher cost of funds leads to negative earnings for FNMA at the end of 1988. Growing concern for FNMA's financial position leads to a widening spread between FNMA's cost of new debt and the rates on Treasury debt. Ultimately, FNMA's purchases of mortgages hare halted, as the financial markets adopt an increasingly negative assessment of FNMA's earnings prospects. The financial markets, housing activity and the economy now suffer, and the federal government faces the prospect of having to rescue FNMA from its worsening financial predicament.

Table 2
Impacts of OMB User Fees
Base Case Scenario

	1983	1984	1985	1986	1987
		--Macro Economy--			
Real GNP ($b)	3275	3492	3575	3653	3753
% Change	3.4%	6.6%	2.4%	2.2%	2.7%
Total Employment (m)	90.19	94.45	97.57	99.14	100.83
Construction	3.94	4.34	4.65	4.75	4.79
Housing Starts (t)	1703	1767	1725	1787	1629
Single Starts	1066	1103	1070	1202	1034
Multi Starts	637	664	656	585	595
Existing Home Sales (t)	2719	2867	3145	3103	3026
Federal Deficit ($b)	-179	-173	-196	-183	-175
		--Financial Markets--			
Originations ($m)	201,609	203,688	214,843	250,919	230,248
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.82	12.16
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.63	10.81
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.83	7.17
20-Year T-Bond Rate (%)	11.34	12.48	10.96	9.41	10.20
MBS Issued ($m)	82,672	57,752	94,285	94,359	74,100

	1988	1989	1990	1991	1992
		--Macro Economy--			
Real GNP ($b)	3862	3962	4069	4175	4287
% Change	2.9%	2.6%	2.7%	2.6%	2.7%
Total Employment (m)	102.92	104.97	107.20	108.77	110.43
Construction	4.86	4.91	5.01	4.98	5.03
Housing Starts (m)	1699	1765	1727	1671	1694
Single Starts	1154	1235	1197	1141	1154
Multi Starts	545	530	530	530	540
Existing Home Sales (t)	3260	3385	3429	3355	3387
Federal Deficit ($b)	-153.34	-147.22	-131.86	-128.24	-118.32
		--Financial Markets--			
Originations ($m)	278,255	319,116	335,474	338,374	363,742
Mortgage Rate-Comm. (%)	11.23	10.90	10.80	10.79	10.60
Mortgage Rate-Closing (%)	10.25	9.94	9.88	9.87	9.75
90-Day T-Bill Rate (%)	6.43	6.40	6.46	6.50	6.50
20-Year T-Bond Rate (%)	9.40	9.17	9.06	8.92	8.72
MBS Issued ($m)	95,667	100,770	101,216	100,467	108,831

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 1
Impacts of OMB User Fees in Base Case
Scenario I: FNMA Passes On Fees in Base Case

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	3275	3492	3575	3653	3752
% Change	3.4%	6.6%	2.4%	2.2%	2.7%
Total Employment (m)	90.19	94.45	97.37	99.14	100.82
Construction	3.94	4.34	4.65	4.75	4.78
Housing Starts (t)	1703	1767	1725	1786	1615
Single Starts	1066	1103	1070	1201	1020
Multi Starts	637	664	656	585	595
Existing Home Sales (t)	2719	2867	3145	3102	3004
Federal Deficit ($b)	-179	-173	-196	-183	-175
	--Financial Markets--				
Originations ($m)	201,609	203,688	214,843	250,714	226,811
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.82	12.25
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.63	10.86
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.83	7.16
20-Year T-Bond Rate (%)	11.34	12.48	10.96	9.40	10.20
MBS Issued ($m)	82,672	57,752	94,285	94,377	76,297

	1988	1989	1990	1991	1992
	--Macro Economy--				
Real GNP ($b)	3859	3957	4064	4170	4282
% Change	2.8%	2.5%	2.7%	2.6%	2.7%
Total Employment (m)	102.86	104.84	107.02	108.61	110.25
Construction	4.82	4.85	4.93	4.91	4.94
Housing Starts (m)	1676	1739	1698	1633	1647
Single Starts	1131	1210	1173	1110	1116
Multi Starts	545	529	525	523	531
Existing Home Sales (t)	3219	3331	3367	3281	3298
Federal Deficit ($b)	-154.30	-149.58	-135.51	-132.70	-124.03
	--Financial Markets--				
Originations ($m)	271,544	310,185	325,221	325,250	346,712
Mortgage Rate-Comm. (%)	11.36	11.05	10.97	11.02	10.88
Mortgage Rate-Closing (%)	10.35	10.04	9.99	10.02	9.94
90-Day T-Bill Rate (%)	6.39	6.32	6.36	6.45	6.47
20-Year T-Bond Rate (%)	9.38	9.14	9.01	8.89	8.70
MBS Issued ($m)	100,388	108,867	112,787	114,830	125,583

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 4
Impacts of OMB User Fees in Base Case
Scenario I: FNMA Passes On Fees in Base Case
Differences

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	0	0	0	0	-1
% Change	0	0	0	0	0
Total Employment (m)	0	0	0	.00	-0.01
Construction	0	0	0	.00	-0.01
Housing Starts (t)	0	0	0	-1	-14
Single Starts	0	0	0	-1	-14
Multi Starts	0	0	0	0	0
Existing Home Sales (t)	0	0	0	-1	-22
Federal Deficit ($b)	0	0	0	0	0
	--Financial Markets--				
Originations ($m)	0	0	0	(205)	(3,437)
Mortgage Rate-Comm. (%)	0	0	0	0.01	0.10
Mortgage Rate-Closing (%)	0	0	0	.00	0.06
90-Day T-Bill Rate (%)	0	0	0	.00	-0.01
20-Year T-Bond Rate (%)	0	0	0	.00	.00
MBS Issued ($m)	0	0	0	18	2,197

	1988	1989	1990	1991	1992
	--Macro Economy--				
Real GNP ($b)	-3	-5	-6	-5	-5
% Change	0	0	0	0	0
Total Employment (m)	-0.06	-0.13	-0.18	-0.17	-0.17
Construction	-0.03	-0.06	-0.08	-0.07	-0.08
Housing Starts (m)	-23	-26	-30	-37	-47
Single Starts	-23	-25	-25	-30	-38
Multi Starts	0	-1	-5	-7	-9
Existing Home Sales (t)	-41	-55	-61	-74	-89
Federal Deficit ($b)	-1	-2	-4	-4	-6
	--Financial Markets--				
Originations ($m)	(6,711)	(8,931)	(10,253)	(13,124)	(17,030)
Mortgage Rate-Comm. (%)	0.13	0.15	0.17	0.23	0.28
Mortgage Rate-Closing (%)	0.09	0.10	0.11	0.15	0.20
90-Day T-Bill Rate (%)	-0.04	-0.08	-0.10	-0.05	-0.03
20-Year T-Bond Rate (%)	-0.02	-0.03	-0.05	-0.03	-0.02
MBS Issued ($m)	4,721	8,097	11,571	14,363	16,752

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 5
Impacts of OMB User Fees
High Rate Case

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	3275	3492	3575	3666	3800
% Change	3.4%	6.6%	2.4%	2.6%	3.6%
Total Employment (m)	90.19	94.45	97.57	99.48	102.18
Construction	3.94	4.34	4.65	4.77	4.95
Housing Starts (t)	1703	1767	1725	1968	1873
Single Starts	1066	1103	1070	1319	1125
Multi Starts	637	664	656	650	748
Existing Home Sales (t)	2719	2867	3145	3273	3266
Federal Deficit ($b)	-179	-173	-196	-169	-124
	--Financial Markets--				
Originations ($m)	201,609	203,688	214,843	281,627	267,366
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.33	11.98
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.33	10.66
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.91	7.60
20-Year T-Bond Rate (%)	11.34	12.48	10.96	8.93	9.93
MBS Issued ($m)	82,672	57,752	94,285	107,536	84,246

	1988	1989	1990	1991	1992
	--Macro Economy--				
Real GNP ($b)	3952	3987	4047	4198	4373
% Change	4.0%	0.9%	1.5%	3.7%	4.2%
Total Employment (m)	106.23	107.58	107.52	109.62	113.83
Construction	5.38	5.25	4.48	4.39	5.15
Housing Starts (m)	1932	1436	1241	1882	2086
Single Starts	1183	896	842	1345	1436
Multi Starts	749	540	399	537	650
Existing Home Sales (t)	3453	2861	2807	3378	3695
Federal Deficit ($b)	-45.24	-61.93	-78.53	-29.71	43.26
	--Financial Markets--				
Originations ($m)	318,522	247,000	240,377	404,096	485,644
Mortgage Rate-Comm. (%)	11.95	13.70	13.11	10.84	10.55
Mortgage Rate-Closing (%)	10.63	11.67	11.67	10.00	9.69
90-Day T-Bill Rate (%)	8.58	10.86	7.50	6.19	6.57
20-Year T-Bond Rate (%)	9.92	10.61	9.91	9.07	9.01
MBS Issued ($m)	97,010	72,602	96,682	141,845	142,343

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 6
Impacts of OMB User Fees in High Rate Scenario
Scenario II: FNMA Passes On Fees in High Rate Case

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	3275	3492	3575	3666	3798
% Change	3.4%	6.6%	2.4%	2.6%	3.6%
Total Employment (m)	90.19	94.45	97.57	99.48	102.14
Construction	3.94	4.34	4.65	4.77	4.92
Housing Starts (t)	1703	1767	1725	1965	1853
Single Starts	1066	1103	1070	1315	1107
Multi Starts	637	664	656	650	746
Existing Home Sales (t)	2719	2867	3145	3259	3238
Federal Deficit ($b)	-179	-173	-196	-169	-125
	--Financial Markets--				
Originations ($m)	201,609	203,688	214,843	280,469	262,754
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.35	12.08
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.34	10.72
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.94	7.59
20-Year T-Bond Rate (%)	11.34	12.48	10.96	8.95	9.93
MBS Issued ($m)	82,672	57,752	94,285	106,215	86,468

	1988	1989	1990	1991	1992
	--Macro Economy--				
Real GNP ($b)	3948	3983	4043	4194	4367
% Change	4.0%	0.9%	1.5%	3.7%	4.1%
Total Employment (m)	106.12	107.42	107.38	109.47	113.64
Construction	5.32	5.18	4.42	4.33	5.07
Housing Starts (m)	1898	1401	1215	1854	2048
Single Starts	1153	866	822	1323	1405
Multi Starts	745	534	393	531	643
Existing Home Sales (t)	3400	2797	2747	3316	3613
Federal Deficit ($b)	-47.77	-65.33	-81.91	-33.52	37.88
	--Financial Markets--				
Originations ($m)	308,655	236,418	231,731	392,458	468,670
Mortgage Rate-Comm. (%)	12.10	13.99	13.40	11.05	10.78
Mortgage Rate-Closing (%)	10.72	11.85	11.87	10.16	9.84
90-Day T-Bill Rate (%)	8.53	10.79	7.43	6.15	6.55
20-Year T-Bond Rate (%)	9.89	10.58	9.86	9.05	8.99
MBS Issued ($m)	101,044	83,143	110,474	156,278	158,365

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 7
Impacts of OMB User Fees in High Rate Scenario
Scenario II: FNMA Passes On Fees in High Rate Case
Differences

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	0	0	0	0	-2
% Change	0	0	0	0	0
Total Employment (m)	0	0	0	.00	-0.04
Construction	0	0	0	.00	-0.03
Housing Starts (t)	0	0	0	-3	-20
Single Starts	0	0	0	-3	-17
Multi Starts	0	0	0	0	-3
Existing Home Sales (t)	0	0	0	-13	-28
Federal Deficit ($b)	0	0	0	0	-1
	--Financial Markets--				
Originations ($m)	0	0	0	(1,158)	(4,612)
Mortgage Rate-Comm. (%)	0	0	0	0.02	0.10
Mortgage Rate-Closing (%)	0	0	0	0.01	0.06
90-Day T-Bill Rate (%)	0	0	0	0.03	-0.01
20-Year T-Bond Rate (%)	0	0	0	0.01	.00
MBS Issued ($m)	0	0	0	(1,321)	2,222

	1988	1989	1990	1991	1992
	--Macro Economy--				
Real GNP ($b)	-4	-5	-4	-4	-5
% Change	0	0	0	0	0
Total Employment (m)	-0.11	-0.16	-0.14	-0.14	-0.19
Construction	-0.06	-0.07	-0.06	-0.06	-0.08
Housing Starts (m)	-34	-35	-26	-28	-37
Single Starts	-30	-30	-20	-22	-31
Multi Starts	-4	-5	-6	-6	-7
Existing Home Sales (t)	-53	-64	-60	-62	-81
Federal Deficit ($b)	-3	-3	-3	-4	-5
	--Financial Markets--				
Originations ($m)	(9,867)	(10,582)	(8,646)	(11,638)	(16,974)
Mortgage Rate-Comm. (%)	0.15	0.29	0.28	0.22	0.23
Mortgage Rate-Closing (%)	0.10	0.18	0.20	0.15	0.16
90-Day T-Bill Rate (%)	-0.05	-0.07	-0.07	-0.04	-0.02
20-Year T-Bond Rate (%)	-0.03	-0.03	-0.04	-0.02	-0.01
MBS Issued ($m)	4,034	10,541	13,792	14,433	16,022

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 8
Impacts of OMB User Fees
High Rate Case

	1983	1984	1985	1986	1987
--Macro Economy--					
Real GNP ($b)	3275	3492	3575	3666	3800
% Change	3.4%	6.6%	2.4%	2.6%	3.6%
Total Employment (m)	90.19	94.45	97.57	99.48	102.18
Construction	3.94	4.34	4.65	4.77	4.95
Housing Starts (t)	1703	1767	1725	1968	1873
Single Starts	1066	1103	1070	1319	1125
Multi Starts	637	664	656	650	748
Existing Home Sales (t)	2719	2867	3145	3273	3266
Federal Deficit ($b)	-179	-173	-196	-169	-124
--Financial Markets--					
Originations ($m)	201,609	203,688	214,843	281,627	267,366
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.33	11.98
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.33	10.66
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.91	7.60
20-Year T-Bond Rate (%)	11.34	12.48	10.96	8.93	9.93
MBS Issued ($m)	82,672	57,752	94,285	107,536	84,246

	1988	1989
--Macro Economy--		
Real GNP ($b)	3952	3987
% Change	4.0%	0.9%
Total Employment (m)	106.23	107.58
Construction	5.38	5.25
Housing Starts (m)	1932	1436
Single Starts	1183	896
Multi Starts	749	540
Existing Home Sales (t)	3453	2861
Federal Deficit ($b)	-45.24	-61.93
--Financial Markets--		
Originations ($m)	318,522	247,000
Mortgage Rate-Comm. (%)	11.95	13.70
Mortgage Rate-Closing (%)	10.63	11.67
90-Day T-Bill Rate (%)	8.58	10.86
20-Year T-Bond Rate (%)	9.92	10.61
MBS Issued ($m)	97,010	72,602

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 9
Impacts of OMB User Fees in High Rate Case
Scenario II: FNMA Reduces Maturity of Debt

	1983	1984	1985	1986	1987
	--Macro Economy--				
Real GNP ($b)	3275	3492	3575	3666	3800
% Change	3.4%	6.6%	2.4%	2.6%	3.6%
Total Employment (m)	90.19	94.45	97.57	99.48	102.18
Construction	3.94	4.34	4.65	4.77	4.95
Housing Starts (t)	1703	1767	1725	1970	1877
Single Starts	1066	1103	1070	1320	1129
Multi Starts	637	664	656	650	748
Existing Home Sales (t)	2719	2867	3145	3275	3272
Federal Deficit ($b)	-179	-173	-196	-169	-124
	--Financial Markets--				
Originations ($m)	201,609	203,688	214,843	281,994	268,469
Mortgage Rate-Comm. (%)	13.78	14.38	13.00	11.32	11.95
Mortgage Rate-Closing (%)	12.66	12.37	11.58	10.32	10.64
90-Day T-Bill Rate (%)	8.62	9.57	7.49	6.91	7.60
20-Year T-Bond Rate (%)	11.34	12.48	10.96	8.93	9.93
MBS Issued ($m)	82,672	57,752	94,285	107,605	84,265

	1988	1989
	--Macro Economy--	
Real GNP ($b)	3952	3979
% Change	4.0%	0.7%
Total Employment (m)	106.23	107.33
Construction	5.38	5.13
Housing Starts (m)	1926	1360
Single Starts	1177	833
Multi Starts	749	528
Existing Home Sales (t)	3445	2766
Federal Deficit ($b)	-45.24	-68.93
	--Financial Markets--	
Originations ($m)	316,708	228,370
Mortgage Rate-Comm. (%)	12.00	14.28
Mortgage Rate-Closing (%)	10.64	12.02
90-Day T-Bill Rate (%)	8.58	10.73
20-Year T-Bond Rate (%)	9.92	10.50
MBS Issued ($m)	99,339	90,767

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

Table 10
Impacts of OMB User Fees in High Rate Case
Scenario II: FNMA Reduces Maturity of Debt
Differences

	1983	1984	1985	1986	1987
--Macro Economy--					
Real GNP ($b)	0	0	0	0	0
% Change	0	0	0	0	0
Total Employment (m)	0	0	0	0	0
Construction	0	0	0	0	0
Housing Starts (t)	0	0	0	2	4
Single Starts	0	0	0	2	4
Multi Starts	0	0	0	0	0
Existing Home Sales (t)	0	0	0	2	6
Federal Deficit ($b)	0	0	0	0	0
--Financial Markets--					
Originations ($m)	0	0	0	367	1,103
Mortgage Rate-Comm. (%)	0	0	0	-0.01	-0.03
Mortgage Rate-Closing (%)	0	0	0	.00	-0.02
90-Day T-Bill Rate (%)	0	0	0	0.00	0.00
20-Year T-Bond Rate (%)	0	0	0	0.00	0.00
MBS Issued ($m)	0	0	0	69	19

	1988	1989
--Macro Economy--		
Real GNP ($b)	0	-8
% Change	0	0
Total Employment (m)	0.00	-0.25
Construction	0.00	-0.12
Housing Starts (m)	-6	-75
Single Starts	-6	-63
Multi Starts	0	-12
Existing Home Sales (t)	-8	-96
Federal Deficit ($b)	0	-7
--Financial Markets--		
Originations ($m)	(1,814)	(18,630)
Mortgage Rate-Comm. (%)	0.05	0.58
Mortgage Rate-Closing (%)	0.01	0.35
90-Day T-Bill Rate (%)	0.00	-0.13
20-Year T-Bond Rate (%)	0.00	-0.11
MBS Issued ($m)	2,329	18,166

$b=billions dollars m=millions t=thousands
$m=millions dollars %=percent

The CHAIRMAN. Thank you very much, Mr. Maxwell.

Could you elaborate a little on why you believe the imposition of these housing taxes—and I think you are accurately describing them when you use the word "taxes," because that's what they are—will actually increase the deficit and not reduce it?

Mr. MAXWELL. Yes, sir. I think that the imposition of these taxes would result in a decline in economic activity in the housing sector, which would result in lower receipts to the Government, and thus an increase in the deficit. And I think that we can see from the experience in 1982 and 1983 just how important housing is to the economy, because once again, it was housing that led the way out of the terrible recession that we had in 1981 to early 1983.

I think to impose this kind of burden on this vital sector of the economy, totally without justification, in that these are not costs to the taxpayers to begin with, would, in fact, increase the deficit.

The CHAIRMAN. Now the Office of Management and Budget, the administration, says that Fannie Mae should pay for its Federal relationship. But I'm not sure what you're getting in return for that payment, if you receive no Federal funds and your debt is not guaranteed by the Government.

What has the administration or the OMB told you is your benefit for paying these fees?

Mr. MAXWELL. The OMB has told me that the benefit that we receive is the ability to tap the capital markets at generally favorable rates. The fact of the matter is that we are able to borrow large sums of money to finance our purchases of mortgages, but we are subject to market conditions. When Fannie Mae was in serious trouble in 1981 and we were losing $1 million a day, our cost of debt rose by about 2 percent and greatly exceeded the costs of borrowing of typically AA or AAA private corporations.

The tradeoff in our statute is simply that Fannie Mae has been put into the private sector to perform a specific social mission, which is to provide a secondary market for low-, moderate-, and middle-income families. We have a limitation on the size of the mortgage we can buy. We are limited to the mortgage business.

The only way in which Fannie Mae is able to carry on that business is by tapping the capital market. Therefore when OMB says that we have a benefit in being able to tap the capital market, they leave out the entire other side of the equation, which is why that benefit is there. The only reason it's there is because the Government has told us what business to do.

The CHAIRMAN. This is the picture you are painting. If Congress should go along with the President and impose these taxes or user fees, to use the administration's term, then, the cost to the average American to buy a home under some of these programs is going to significantly increase. That includes the closing costs as well as the cost over the term of the mortgage; is that correct?

Mr. MAXWELL. That's correct, sir.

The CHAIRMAN. Well, let me as you a question. Is there anybody else, some other lender, who would step up and take the place of Fannie Mae and reduce that cost?

Mr. MAXWELL. There is no other entity except Freddie Mac that is dedicated to being in the mortgage market day in and day out, buying these low-, moderate-, and middle-income mortgages. And

there is no sign that anybody that didn't have the kind of mission that Fannie Mae is charged with carrying out would feel any obligation to do what we do.

Theoretically that's possible, but, in fact, clearly anyone that is in a business feels free to go in and out of that business, depending on what the economic conditions are, particularly if they have a diversification. We have no diversification. We didn't go into some other business when the market gets bad as it did in 1982. We did then what we were set up to do, and I do not see anyone else that's available to do that job.

The CHAIRMAN. Well, what about Freddie Mac? Could Freddie Mac step up to the bar and do that? As I understand it, they also have some fees and taxes that are being levied against them in the administration's proposal. Could they—where are they on this issue? Are they in support of your position?

Mr. MAXWELL. Well, Freddie Mac is in a slightly different position, relative to the administration, than we are. The only citation I can give you to their position is a question asked of their acting president recently as to their position on user fees. He said that he felt that anything that added to housing costs was not a good thing.

But I believe that that's as far as they're allowed to go, because they are really part of the administration, whereas we are not.

The CHAIRMAN. What about the League of Savings Institutions and other housing groups?

Mr. MAXWELL. Well, as a I cited in my statement, the housing groups are united as really they have been on no other issue in recent years. And I would anticipate that the U.S. League of Savings Institutions will also oppose these proposals. Their legislative committee is meeting in the near future.

The CHAIRMAN. Let me ask one last question before yielding.

Chase Econometrics says that there is a concern not only about the effect of the user fee or these taxes on Fannie Mae, but on the whole economy. Are you aware of that statement by Mr. Chimerine, and what does he mean? Would you comment; would you elaborate? What do they mean by not just the effects upon Fannie Mae but upon the entire economy?

Mr. MAXWELL. Well, I think first of all, he means the effects to which I've already referred in terms of the reduced housing activity and the increased deficit.

Beyond that, he refers to the fragility of the financial system. A great deal of Fannie Mae's debt is held by small banks and savings institutions and State governments throughout this country. If this proposal were ever to be adopted by the Congress, as proposed by OMB, there is no question in my mind, as chairman and chief executive of Fannie Mae, that we would be in very serious difficulty. And that, of course, would pose a threat to all the holders of our debt.

We see the problem of the farm credit system; we see the problems of so many thrift institutions today; we see bank failures at a high that hasn't been equaled in years and years. It seems to me irresponsible, to put it mildly, to now come along and propose something that could affect the soundness of Fannie Mae and the housing finance system of the country.

The CHAIRMAN. Thank you very much, Mr. Maxwell.

The gentleman from the State of Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. Maxwell, why not a limit on principal residence, limit it to just principal residences? I think that proposal makes some sense within the administration proposal.

Mr. MAXWELL. Well, I think that you have to remember that the FHA returns money to the Government. The major single family mortgage insurance program earned $161 million, as I recall the figure, in 1985. And I don't see any ground for restricting the program to principal residences under those circumstances, especially if you're talking about deficit reduction.

If you're talking about policy that would be made in the other committee, Mr. Lowry, then that is an issue that could be addressed. But I don't think that it is appropriate to address it under the heading of deficit reduction. It's not deficit reduction. It's a change in policy.

Mr. LOWRY. Do you know—because this would be a quite small part of this proposal, I mean, this would be a very small part.

Do you happen to know what sort of dollars the administration proposal attaches to that, the limiting to principal residence question?

Mr. MAXWELL. No, sir; but I can certainly get that answer for you.

Mr. LOWRY. If you would, please, because I assume it's a very small part of what we're talking about here, this overall thing.

Mr. MAXWELL. It must be, yes.

[The following information was supplied for the record:]

The administration projected no specific dollar savings from its proposal to limit the FHA insurance program to principal residences. The philosophical basis of the proposal is exposed because there are no estimated savings. The OMB simply wants to curtail use of the FHA insurance programs.

Mr. LOWRY. Just a second one along that line. I think you give pretty good evidence as to the effect of the limit on $40,000 gross family income. But should we have a lid? I mean, is there another number—and again, this is a policy question, I think, just as the last one—but should there be, from a policy standpoint, a lid?

Mr. MAXWELL. Well, there is a mortgage ceiling right now, and I think that the current one is appropriate.

Mr. LOWRY. And that is how much?

Mr. MAXWELL. I think it's about $67,500, and then the Secretary of HUD has the ability to increase it by 33 percent.

Mr. LOWRY. Within the high area.

Mr. MAXWELL. That's right.

Mr. LOWRY. So there is a lid at this time which really hits right in almost that medium price range we're now looking at.

Mr. MAXWELL. Well below the median price range for houses in this country at this time.

Mr. LOWRY. What is the median price range?

Mr. MAXWELL. The median price is over $80,000, and the average price is about $100,000.

Mr. LOWRY. All right, thank you. So we do have a lid. This isn't just something that's going to millionaires or something.

Mr. MAXWELL. No, sir; and so, of course, do Fannie Mae and Freddie Mac.

Mr. LOWRY. Last year when we killed this dumb proposal, I thought there was some discussion about the lack of ability to pass on to the existing mortgage owners the user fee, and what that would do to Fannie Mae. Now I haven't read anything this year on this, and so I may be recalling that incorrectly.

Can you pass this on, the user fee?

Mr. MAXWELL. Well, clearly, as a business, we would have to try to pass along to the extent we could. But no, we could not pass along a user fee of the dimensions proposed here, and that raises the question which OMB really refuses to face, and that is that we are competitive. We have competitors, and we're in the marketplace. We're not some monopoly at all. And so, no, we would not be able to pass this along. We would have to absorb a good deal of it, and it could be tremendously harmful to our financial position.

Mr. LOWRY. How did you do last year? What are the numbers?

Mr. MAXWELL. Last year we made $38 million.

Mr. LOWRY. What about the previous year?

Mr. MAXWELL. The previous year we lost about $57 million.

Mr. LOWRY. Any estimate of what this user fee would do, relative to say the $38 million net profit last year?

Mr. MAXWELL. If it had been in existence last year?

Mr. LOWRY. Yes.

Mr. MAXWELL. Oh, it would have wiped out our profit. We would have lost a lot of money.

Mr. LOWRY. Well, how long could you continue to do that?

Mr. MAXWELL. Obviously not very long.

Mr. LOWRY. So we are talking about a significant policy decision here.

Mr. MAXWELL. Only until the Congress decided that they had to do something about it.

Mr. LOWRY. I appreciate that you address the subsidized housing question also. The administration proposal, as I count it, is moving—not even talking about new construction or substantial rehabilitation—even setting that aside and taking the existing housing subsidy rents, is moving from the combination of rural and section 8 and a couple of the smaller programs—perhaps from around 120,000 units to replace by 50,000 vouchers.

What happens to those 70,000 families that—and I use that number, 70,000 and that 120,000 is my estimate because I have taken out the new construction—substantial rehab and that is a different question. What happens?

Mr. MAXWELL. Well, my own view, Mr. Lowry, is that we are simply kicking this problem along. It will fester and grow and at some point we are going to have to do something for those families and many other families whose housing is inadequate.

I might tell you that I am familiar with a project here in northeast Washington which is seeking to lower the incidence of infant mortality of women in a particular area of the city. And they have enrolled these pregnant women in this program. By far, overwhelmingly, the No. 1 complaint and problem for these women is housing. There is no public housing available. There is no decent housing available.

Mr. LOWRY. With the chairman's indulgence.

Since this need and waiting list is there, how come the market does not step forward and meet it? I mean, obviously——

Mr. MAXWELL. Because the market cannot make enough money doing it.

Mr. LOWRY. There is certainly not a lack of demand for the market to move into, correct?

Mr. MAXWELL. That is correct.

Mr. LOWRY. It is just that the people cannot possibly make the payments to pay for the unit.

Mr. MAXWELL. That is correct.

Mr. LOWRY. Thank you.

Mr. MAXWELL. Thank you.

The CHAIRMAN. The time of the gentleman has expired.

The gentleman from Massachusetts.

But before the gentleman from Massachusetts begins, Mr. Maxwell, I am going to have to apologize. I am going to have to leave the Chair to go to an emergency meeting.

I would like to simply thank you for your testimony and I appreciate the candor with which you have delivered it. And certainly, as we look at these priorities, and make decisions about the 1987 budget, your views will be taken into consideration.

The gentleman from Massachusetts.

Mr. ATKINS. Thank you, Mr. Chairman.

Mr. Maxwell, could you put the chart back up that summarizes the Chase Econometrics study? And who was that study financed by?

Mr. MAXWELL. By Fannie Mae.

Mr. ATKINS. That was financed by you?

Mr. MAXWELL. Absolutely.

Mr. ATKINS. But Chase Econometrics stands behind the independence of their evaluation?

Mr. MAXWELL. Yes, I think Chase Econometrics is not for sale. They are a very highly respected, independent economic organization and we got them to do the study, but we did not tell them what to conclude.

Mr. ATKINS. Is OMB aware of that study?

Mr. MAXWELL. We have sent it to them, yes.

Mr. ATKINS. Have you gotten a response from them?

Mr. MAXWELL. No, sir.

Mr. ATKINS. Has there been any response from any agency or group, backing the administration proposals that sought to criticize or contest the findings of the Chase study?

Mr. MAXWELL. No, sir; and I do not know of anyone backing the administration's proposals except the OMB.

Mr. ATKINS. The administration claims that the savings from the proposal would be—or the deficit reduction over a period of 5 years would be $2.4 billion. Is that correct?

Mr. MAXWELL. They estimate that all the housing fees or taxes, whatever you call them, that would be collected would amount to that much. I think that is right.

Mr. ATKINS. And according to Chase, according to the two scenarios—rising and declining interest rates—would be the net effect of deficit increase because of slower economic growth in the country?

Mr. MAXWELL. Well, in the case of the declining interest rates, the deficit increase Chase estimates to be about $17 billion.

In the case of the rising interest rates, it is harder to estimate. The figure that they use in the study, I believe, is about $19 billion. But who knows what would be involved if the effects on Fannie Mae came to pass.

Mr. ATKINS. So, in essence, even if Chase were off by a factor of five, you still probably would not see any deficit reduction. Is that fair to say?

Mr. MAXWELL. They could be off by a larger factor than that, yes, sir.

Mr. ATKINS. One of the concerns that I have, with this proposal, the administration claims that this is a user fee because of that concept that you are able to borrow or to have access to capital markets at essentially Treasury rates.

Assuming as you go out of business, as you feel that you would were these fees imposed and were you to have to pass them on, et cetera, et cetera, I am presuming that in good housing markets that private lenders would step up to the plight and would get into this business. Is that fair to say?

Mr. MAXWELL. I think that it is a somewhat shortened version of what might ultimately happen. The secondary market has become even more important to the mortgage market in recent years. There are a lot of reasons for that, which I will not go in to.

Mr. ATKINS. But is it not fair to say that there are people, there are private ventures that do not have the special access to capital markets that you have, that are in the secondary market from time to time, is that fair?

Mr. MAXWELL. That is right, but not all the time. And if a good housing market remained good indefinitely then it is possible that its entities would provide that market. But if interest rates went up and other factors intervened, they might not do so.

Mr. ATKINS. So what essentially would happen, one presumes that since the housing markets are volatile enough, the secondary market is even more volatile than the housing market—particularly the market for middle and lower income housing. What you would do then, I presume, would be exacerbate the ups and downs of the housing market.

Mr. MAXWELL. You are precisely right.

Mr. ATKINS. And how much do you—did Chase indicate, in their study, anyplace or do you have any data to indicate how much more we would add to the up and down swings in housing prices and in housing starts particularly?

Mr. MAXWELL. Well, in housing starts, Chase did have the figures which appear on the chart. And in the volatility of secondary market activity it is not specifically covered in the studies.

It is an extremely interesting question and I would like to provide an answer for you, Mr. Atkins.

Mr. ATKINS. I would be interested in seeing that, if you could get it.

[The information referred to above follows:]

HOUSING AND THE SECONDARY MARKET

The secondary market has become progressively more important as a means of channeling funds to home buyers. In the 1970's, sales into the secondary market amounted to about 35 percent of all single family mortgage loans originated in the country. In 1980 and 1981, that proportion jumped to a little over 50 percent, and in the last 4 years (with partially estimated data for 1985) it rose to nearly 87 percent, inclusive of swaps of seasoned loans.

Fannie Mae's activities have been an important element in the increased importance and efficiency of the secondary market. Without Fannie Mae's participation, secondary market transactions as a percent of total originations would have been only 70 percent in the past 4 years, instead of 87 percent.

Almost certainly, this reduced level of secondary market activity would have resulted in higher levels of mortgage rates and lower volumes of home sales and housing starts. It is difficult, however, to quantify the precise amount of these effects, and we did not specifically request that Chase Econometrics address this issue.

Mr. ATKINS. A final question is that the administration last year offered a proposal that was about 50 percent of this proposal that they have offered this year. They have, I believe, no support from any member, Republican or Democrat, on this Budget Committee and on the Budget Committee in the Senate. They had, to my knowledge, virtually no support from anybody in the Banking Committee. I cannot think of a single person.

Why would the administration—perhaps this is a leading question, but why would they if, for half a loaf, they had zero support, why would they give us a whole loaf this year? What could possibly be the reasoning behind that?

Mr. MAXWELL. Well, I think, probably you would be, as a Member of Congress, more in a position to understand their reasoning than perhaps I am.

Mr. ATKINS. I was hoping for a little more fiery rhetoric than that.

Mr. MAXWELL. Well, I think—as I said in my statement, it is an ideological position.

Mr. ATKINS. Well, what effect is that having on your ability? You have how many employees at Fannie Mae?

Mr. MAXWELL. We have 2,000.

Mr. ATKINS. What effect is that having on the overall morale and your ability to carry out your mission, this concept that you have got a sword of Damocles hanging over you and that you are essentially in an ideological confrontation with the administration? Do they have any allies whatsoever and——

Mr. MAXWELL. They have no allies that I am aware of. But of course, when the administration makes a proposal like this, one takes it seriously.

And it does have a very seriously adverse effect on morale. I appreciate your raising it.

Mr. ATKINS. There are no fundamentalist groups that feel that this violates the New Testament or the Old Testament or anything?

Mr. MAXWELL. Not that I am aware of, but maybe they do not know about it, yet. [Laughter.]

Nobody that follows these things, that I am aware of, favors this proposal. It not only has an adverse effect on morale, but it also has a very specific effect on our cost of funds because the market looks at a proposal like this. It is made by the administration in power. And the market says hey, wait a minute. Maybe we ought

to add a few points on to Fannie Mae's cost of debt just to hedge against the possibility this might pass.

Mr. ATKINS. That is for your cost of funds for your capital that you get through private equity markets?

Mr. MAXWELL. Through the equity and the debt markets.

Mr. ATKINS. And how much—do you have an estimate as to how much that added to your cost of funds last year?

Mr. MAXWELL. When it was proposed last year? Well, I know that it had an immediate effect on the price of the stock, which went off after the proposal was made. And it was then selling for about $18. It went off about 3 points.

On the cost of debt, I do not have a dollar estimate, but it certainly would be in millions of dollars that it cost us, just for the proposal having been made.

Mr. ATKINS. Do you feel you could, based on what happened to your stock prices and other things, that you could come up with a rough sense of what that cost was and how much that then increased costs for housing for people?

Mr. MAXWELL. I could certainly try.

Mr. ATKINS. That would be very helpful.

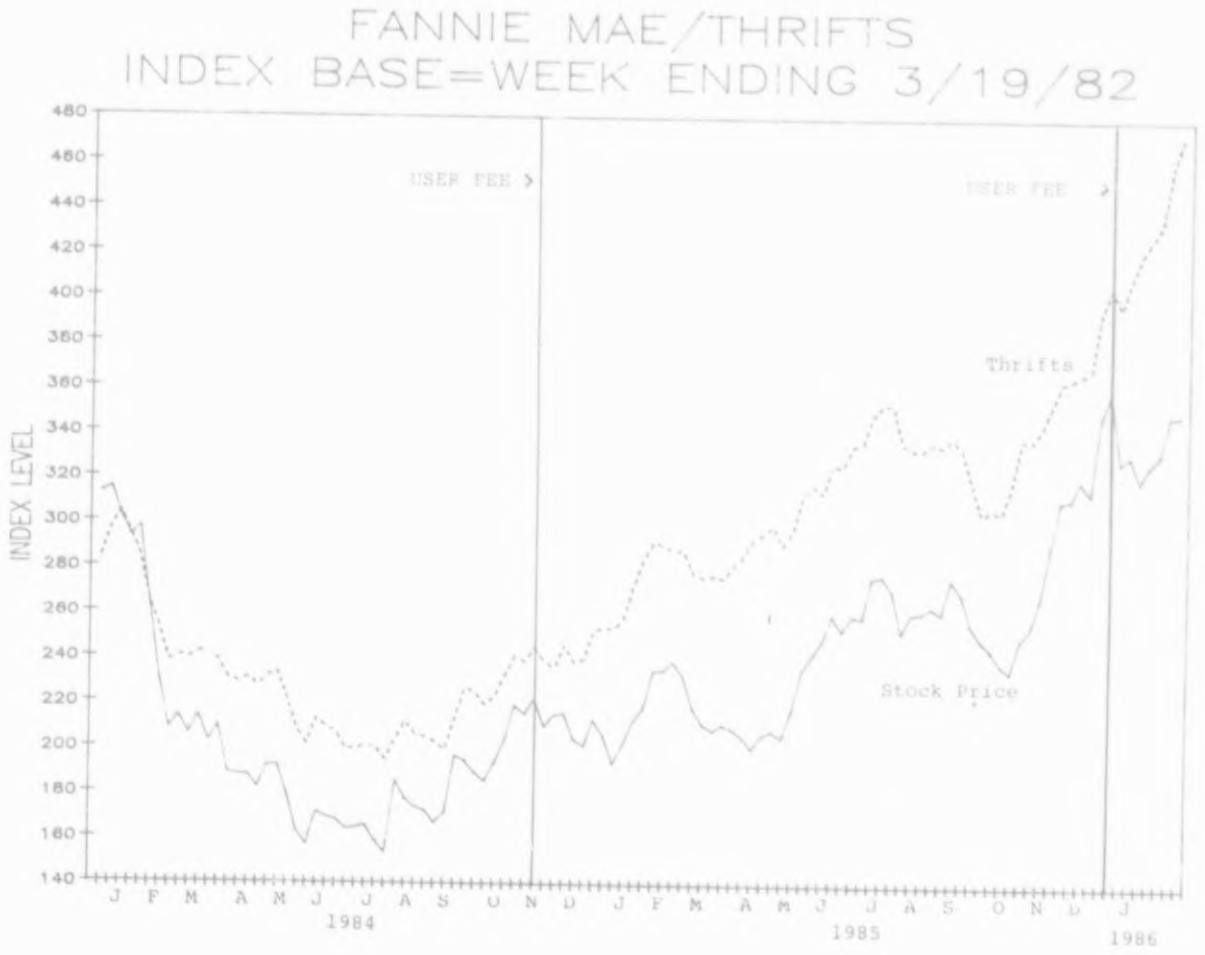
[The information referred to above follows:]

REACTION OF STOCK MARKET TO USER FEE PROPOSALS

The 1984-1985 user fee proposal had a measurable effect both on Fannie Mae stock price and debt cost. As reflected in the following graph, prior to the first rumors of the administration's user fee proposal, which surfaced in November 1984, Fannie Mae's stock tracked the market fairly closely. That is, the movement of Fannie Mae's stock essentially paralleled the thrift stock index. In November 1984, our stock lost significant ground as the market responded to the administration's user fee proposal. A similar market response was experienced in December 1985 when the administration put forward its new user fee proposal.

Fannie Mae's debt cost was also affected. The rates on Fannie Mae's 3- and 5-year debentures averaged 23 and 25 basis points, respectively, above comparable maturity Treasury rates in November and December 1984. The user fee proposal was announced in late December. Subsequently, in the first 3 months of 1985, Fannie Mae's debt spreads over 3- and 5-year treasuries rose to 31 and 33 basis points, respectively. Interestingly, this 8 basis point increase was virtually identical to the amount of the fully phased-in user fee. By June and July 1985, however—as prospects for user fee legislation became less likely in the eyes of the market, Fannie Mae debt spreads on 3- and 5-year issues returned to roughly their levels of the previous November and December, before the user fee announcement.

There is little doubt that the mid-December sinking spell in Fannie Mae's stock price was in some way related to the user fee announcement. Because many factors influence Fannie Mae's debt costs, it cannot be said for certain that the first quarter 1985 increase in debt spreads reflected solely the announcement on user fees. However, the timing (and magnitude) of the debt spread increase are suggestive that user fees may have been the cause.


FANNIE MAE/THRIFTS
INDEX BASE=WEEK ENDING 3/19/82
INDEX LEVEL
480
460
440
420
400
380
360
340
320
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220
200
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140
USER FEE
USER FEE
Thrifts
Stock Price
J F M A M J J A S O N D J F M A M J J A S O N D J
1984
1985
1986

Mr. ATKINS. If you were trying to avoid having that same kind of cost imposed this year, what would your recommendation to this committee and to the Congress be in order to remove the cloud over the housing markets?

Mr. MAXWELL. My strong recommendation is that the Budget Committees of both the Senate and House would take this off the table at the earliest possible time.

Mr. ATKINS. Take it off the table immediately?

Mr. MAXWELL. Yes.

Mr. ATKINS. And you feel that would have a strong positive impact on your cost of capital in private markets?

Mr. MAXWELL. I think it would, yes.

Mr. ATKINS. Are we talking about something in the millions of dollars?

Mr. MAXWELL. Yes, I am. And I am talking about our activity in the mortgage market as well, because you see we give commitments that stretch over a period of time. And those commitments are priced, when they are taken down, by the mortgage lender. If the mortgage lender believes that we are going to have this unexpected, extra cost involved, that makes the mortgage lender less willing to enter into that commitment.

And that, in turn, of course, provides less money for the mortgage market.

Mr. ATKINS. Would that have an effect on the number of housing starts?

Mr. MAXWELL. It could ultimately have an effect, yes.

Mr. ATKINS. If you could, either through your own economists and your staff or through Chase, get us your analysis of those things, I think that would be very helpful.

Mr. MAXWELL. Yes, sir.

[The information referred to above follows:]

IMPACT OF USER FEE PROPOSAL ON FANNIE MAE PROFITS

As noted in the previous response to Mr. Atkins, the most recent user fee proposal by the administration seemingly also affected Fannie Mae's stock prices in comparison to that of the thrift industry. We are, however, unable to attest with any great certainty that the proposal alone was the cause for that drop in prices. In December, the thrift industry as a whole—strengthened by diversified business authority—announced record profits in 1985. Fannie Mae, however, had only modest profits during the same period.

The specific impact of the administration's new user fee proposal is thus more difficult to ascertain. Quite possibly little adverse consequence has yet been felt because our debt and equity buyers do not believe that the current proposal will become law, given that a much milder version of the user fee proposal was defeated last year. The longer the user fee idea remains "in play," however, the more likely it is that more dramatic adverse investor reactions will occur. Already Fannie Mae has had one customer request that it agree to rebate the price of the standby commitment in the event that user fee legislation is passed. More such behavior might be anticipated if the user fee proposal is not immediately withdrawn or defeated.

Mr. ATKINS. Thank you very much.

Mr. MAXWELL. Thank you.

Mr. LOWRY [presiding]. I think the gentleman from Massachusetts asks some very good questions.

Mr. Maxwell, thank you very much for meaningful and helpful testimony.

Mr. MAXWELL. Thank you, Mr. Lowry.

Mr. LOWRY. This hearing is adjourned.

[Whereupon, at 11:55 a.m. the committee adjourned until Thursday, February 27, 1986.]

IMPACT OF THE PRESIDENT'S 1987 BUDGET

THURSDAY, FEBRUARY 27, 1986

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:15 a.m., in room 210, Cannon House Office Building, Hon. William H. Gray III (chairman of the committee) presiding.

The CHAIRMAN. The committee will now come to order.

Today the committee continues its hearings on the fiscal year 1987 budget with a panel of distinguished representatives of State and local governments.

I want to welcome to the committee the president of the National League of Cities, Mayor Henry Cisneros; president of the U.S. Conference of Mayors, Mayor Ernest Morial, who is accompanied by Mayor Ed Koch, of New York City; Commissioner Chuck Williams, of Atlanta, GA, fourth vice president of the National Association of Counties; and Delegate Lucille Moore, of Maryland, representing the National Conference of State Legislatures.

The House Budget Committee recently completed 5 days of field hearings across the Nation. We had the opportunity to discuss the Federal budget with local and State officials and a large cross section of interested parties. The President's budget served as the focal point for much of this testimony, but we also received many suggestions on what an alternative budget could look like.

Our testimony to date has not revealed significant support for the President's budget proposals. While there was universal agreement that the deficits have to be significantly reduced, there was also an overwhelming sense that the President's budget proposals were not balanced.

I found it particularly interesting that State and local officials, who also have had to face the difficult task of balancing their budgets, testified that budget deficit reduction required a broader approach which spreads the sacrifice across all parts of the budget. Mayors and Governors repeatedly advised us that, "Everything should be on the table, everything, including domestic spending, defense spending, entitlements, and revenues."

Mayors and Governors have been through a fiscal retrenchment during the 1982-83 recession, and they often found it necessary to reduce their services and raise revenues in order to balance their budgets. Now, many cities and States are experiencing a strong fiscal and economic recovery and are finding it possible to increase services, reduce taxes, and, frequently offset some or all of the present reductions in Federal grant assistance.

However, other States and localities are still experiencing a significant degree of fiscal distress, particularly in regions affected by the farm crisis, falling oil and energy prices, and severe international competition reflected in the record $148.5 billion trade deficit.

The President's State and local budget proposals do not take account of these disparities among States and localities. The 1987 budget proposals assume $89.1 billion in new budget authority for a total grant assistance to States and localities, which would be a $27 billion decrease compared to the CBO 1987 baseline. This would be a reduction of approximately 25 percent in just 1 year.

Whether in terms of total budget outlays or percent of total GNP or as a percentage of State and local receipts from our own sources, the President's grant assistance proposals attempt to turn back the hands of time to levels last seen prior to the 1970's. The President's budget represents another new federalism proposal, but without any transfer of fiscal resources or assumption of current State and local responsibilities as a tradeoff.

I am concerned with the fact that his proposals do not reflect any consultation or partnership with the States, the localities, or the Congress.

Today, we are asking you as State and local officials to testify as to what an appropriate policy of Federal assistance to States and localities should be in a period requiring significant reductions in the Federal deficit. The committee needs to know your program priorities and what Federal and State responsibilities might be appropriate candidates for either reform or reduction. As elected local and State officials, you are on the proverbial firing line. You understand the difficult choices that we must make.

The committee sincerely appreciates your assistance as we proceed to formulate a budget resolution with an appropriate set of program priorities. At the same time we must achieve substantial deficit reduction.

We will now ask the first panel to the witness table. We will ask you to take your places, Mayor Cisneros, Mayor Morial, Commissioner Chuck Williams, and Delegate Lucille Maurer. If you would, come forward and take the seats at the witness table.

Let me first remind you that we have printed copies of your testimony. It will be submitted in its entirety in the record. We would appreciate it if you could summarize your testimony so that we can spend more time in question and answer periods.

Normally, in these proceedings I would turn to the ranking Republican member and ask him if he would like to have an opening statement. Unfortunately, there is no one to my left that I can turn to. I have been informed that the Republican members are busy doing something else this morning and unavoidably cannot be here to hear your testimony.

However, I want you to know that we will present them with your testimony. It will be in the record even though none of them are here today to hear your concerns and your testimony about what our budget priorities should be.

So, we would ask you to testify and summarize, and we will put your entire testimony into the record. We would like to proceed by

asking Mayor Cisneros to go first. Mayor Morial, Commissioner Williams, and Delegate Maurer, please proceed.

STATEMENT OF HON. HENRY G. CISNEROS, MAYOR OF SAN ANTONIO, TX, AND PRESIDENT, NATIONAL LEAGUE OF CITIES

Mr. CISNEROS. Thank you very much. Allow me first to compliment you on the tough job, but the good job, that you are doing and congratulate you on the recent hearings out across the country and particularly, Mr. Chairman, on the excellent job that you are doing as an individual. I know that this responsibility has changed your life. But many people are proud of you and are glad that you are in that seat.

We have submitted testimony, as you said, and I would like simply to expand on some of the points that were made in that testimony. I speak today on behalf of some 16,000 cities that are either directly or indirectly members of the National League of Cities and which, when their populations are taken together, amount to something like 80 percent of the American people.

While it is true that I speak as a mayor and on behalf of the cities, I would like to expand my thoughts just a bit this morning and talk to you about a broader issue in this budget, and that is the fundamental American idea, the notion of equality in our society. The notion of equality is more than a historic fact. It is more than an abstraction. It is the glue, if you will—more importantly, I think, the lubricant—that keeps our society working. It makes the gears of the society work.

If people feel there is a sense of fairness, perception of fairness and equality in American life, then the chances are that they are able to sacrifice something in the short run, indicate some patience, so that their children in their future years, or they in their future years, might be able to gain more from life.

It seems to me that that sense of equality is diminishing in American life today because of some massive forces which have been unleashed on the society. We have always had these kinds of forces in effect, but in previous generations, at least over the last 50 years, governments stepped in to cushion or mitigate the worst effects of those forces.

If we were to try to quickly comprehend some of the things happening in our country today that could well lead to a more unequal society, we would have to look, for example, at the effects of the decline of manufacturing in our country. A Nation that had 60 percent of its people working in manufacturing in 1960 now has about 20 percent working in manufacturing. And the effect of that in cities such as Akron, OH, for example, can only be a reduction of incomes and a less equitable distribution of income.

Related to that force is the global economy. More than one out of four cars now driven on American roads are manufactured abroad, as are more than one out of five personal computers, one out of three pairs of shoes, virtually every video cassette. Steel has declined by some 45 percent since the mid-1970's.

A city like Pittsburgh, for example, once a great, thriving metropolitan area, has had to redefine itself in the last few years, with the loss of the steel industry.

Still another force impacting upon equality in our country is the movement of people across the landscape of America from the older industrial cities to the new and growing cities of the Southwest. Totally new places have come into existence. San Jose, CA; Phoenix, AZ, which were barely cities after the end of the war, are today large cities with needs. And if they are going to be places for people to live and fare, they have to be able to build infrastructure in those places.

Even as we find the flip side of that coin, older cities with large concentrations of poor and elderly, the demographics of the country are changing, too, and they make for a more unequal society, with more elderly people than ever before as a percentage of the population. For the first time, in 1990 we expect that there will be more people over 65 years of age than there are teenagers in the society.

All of these forces, combined with slower growth, have tended to once again allow the poverty percentages in our society to increase and have resulted in a society that is more unequal.

One of those institutions that has traditionally been a force for equality in our society has been the American city. It is there that immigrants come when they want to start their track on the ladder of upward mobility. It is there that large numbers of people who are poor are concentrated. And I think it is very clear that if our cities are allowed to go the way of many of our manufacturing industries into obsolescence and decline, then there is no way that America will not be more unequal.

And yet, what we are seeing at this critical time is not a Government that seeks to intervene to mitigate the effects of inequality but, instead, a Government seeking to withdraw from the stage. Cities are looking at 35-percent cuts in their priority programs in this budget year.

Of the total rescissions now proposed, 65 percent are in the cities' top priorities. CDBG has already been cut 16 percent retroactive to last month. Revenue sharing is slated for elimination. This is a bipartisan program introduced first by Walter Heller when he was chairman of the Council of Economic Advisers, and then backed by President Nixon, and now we find a total divergence from those policies of building the capacity of the cities by eliminating revenue sharing.

Employment and training programs will be cut, and housing assistance will be cut dramatically. So, the cities are going to be hurt badly by what is happening on the spending side.

The other side of the coin that is going to hurt cities badly are the initiatives that are occurring in the Tax Code. I understand the tendency in particularly of a committee like this to want to separate what is happening on the spending side from the Tax Code. But in the cities we catch it from both sides. On the one hand the money is reduced, and on the other the capacity to fend for ourselves is eliminated.

Leaving aside the issues of deductibility of State and local taxes and tax-exempt bonds, which is not the purview of this committee, nevertheless let me suggest that it is appropriate to cross that Berlin wall from thinking about just the budget and spending, to

thinking about the kind of expenditures that are buried deep in the Tax Code.

In talking about freezing or cutting domestic programs, Senator Durenberger recently had important things to say.

He said:

> It really is not cutting across the board at all when we cut just from the budget side. All we do is hurt those who receive their Government subsidies through spending. It does not get to the Americans whose subsidies are hidden in the Tax Code. It says, for instance, is it fair to freeze spending on food stamps while we continue the deduction on corporate lunches? Is it fair to freeze mass transit subsidies while a number of corporations are claiming accelerated depreciation for corporate jets and luxury autos continues to climb?

One might add to the Senator's list. Is it fair to increase the Federal tax for special capital gains for timber by 150 percent or increase deductions on vacation homes, while eliminating senior citizen low-income housing? Is it fair to increase tax expenditures for accelerated depreciation to build a vacant office building by $500 million, while cutting total CDBG appropriations to under $3 billion total? Is it fair to reduce mass transit in the cities, while allowing for writeoffs of leases of jet aircraft that increase from $4.3 billion in 1980 to almost $8 billion in 1985?

Mr. Chairman, speaking just as one mayor and looking at the effects of the program cuts for the cities, I would like to speak strongly in favor of the community development block grant program, CDBG, and I would just like to give you a sense of how that affects the cities.

As you know, CDBG is the evolution of all those programs that were once categorical programs, urban renewal and housing initiatives and money for central city parks and libraries. And it has all been blocked up since the early 1970's. And yet, they are targeted in such a way that they help the poorest of our populations.

If we lose that money in every city of this country, it will not be possible to raise taxes to target money on the poorest of our people. We might be able to raise taxes for additional police citywide, we might be able to raise taxes to replace some fire that we lose when we lose revenue sharing. But I submit to you it would be virtually impossible to raise taxes to spend it in poverty neighborhoods on housing, on streets, on longstanding needs in those areas.

So, when you ask me about priorities, clearly CDBG is up near the top of the list in city after city across this country, and we need this Budget Committee to take a good, hard look at that program as well as employment and training programs which cannot be replaced any other way, housing initiatives, which are not going to be replaced any other way.

And we think there is some opportunity if we cross that Berlin wall from the budget to the Tax Code to look at some 400 billion dollars' worth of money in that Tax Code. As I say, in the final analysis, what we're talking about here is more than just the cities lined up here as another lobby group, more than the oil lobby or the real estate lobby. We're talking about an instrument that has made it possible for countless generations of Americans to climb that ladder and to achieve something like the American ideal of equality.

If we lose that because we lose the viability of our cities to perform in that fashion, that instrumentality of government, the cities, if we lose that, then I think what we will have lost is something very profound: The sense of Americans that they are living in a country that is still believing in ideals and a Nation working for all its people, that sense of equality which makes it possible for people to sacrifice now in order that there is a better life around the corner.

If we lose that, we are going to be a Nation of people who demand everything now, with adversarial hostility. And those are the stakes in this budget discussion, a lot more than programs or even individual cities. It is really a matter of fundamental American ideals.

Thank you, sir.

[The prepared statement of Mr. Cisneros follows:]

PREPARED STATEMENT OF HON. HENRY G. CISNEROS

Good morning. My name is Henry Cisneros. I am the mayor of San Antonio, and the president of the National League of Cities.

I am grateful for the opportunity to appear this morning on behalf of the publicly elected officials of our 16,000 direct and indirect member cities and towns. We are the oldest public interest organization representing nearly 80 percent of all Americans.

The topic on which I have been asked to testify this morning is the one of greatest priority to municipal elected officials—the Federal budget and its impact on the Nation's cities and on the Federal deficit. For over 5 consecutive years, our highest priority has been to achieve a fair and balanced deficit reduction in order to enable our nation to move ahead.

This morning I am prepared to offer our recommendations on Federal deficit reduction, as well as our willingness to work with this committee on early and constructive solutions.

This Nation, more than any other, has benefitted from a strong Federal-State-local partnership. That partnership, created and built upon by generations and generations of Americans, has enabled us to be a leader throughout the free world in terms of providing hope and opportunity for all citizens. It has provided us with an extraordinary physical and human infrastructure.

Yet we have seen in recent years that this partnership is in the process of being dismantled. We have seen that the national goals of decent housing, educational opportunities, adequate health care, and access to employment opportunities are no longer national priorities.

Our country will be as strong as the individuals and families who live here. We will compete as well as we are encouraged. We will succeed to the extent we invest in success.

We will watch others take our place to the extent we are unwilling as a Nation to make a full commitment.

It is, Mr. Chairman, disconcerting that—for the fifth consecutive year—the administration has requested a substantial increase in foreign aid, but a substantial reduction in the investment in our partnership.

I do not criticize the intent and purpose of these foreign aid requests. They are to provide economic opportunity, growth, and security to the cities and towns and the inhabitants of foreign nations. It is a recognition that the strength of their governments will be based upon their domestic institutions and the investment in their own domestic governmental institutions.

What gives me pause is that we have chosen to pursue such an opposite course here. At a time when we, as a partnership, need to make an enormous investment in our children to enable them to compete against the Soviets, the Japanese, the Koreans, and others; at a time when we need to make massive investments to repair and rebuild our most basic infrastructure; we seem to be turning away.

Revenue sharing is now something that is good for communities in foreign nations, but not in ours. We have revenue to share with Cairo, Egypt, but not Cairo, IL. It is a disparity which is difficult to explain—especially given that a portion of that revenue comes from Cairo, IL.

This year, Mr. Chairman and members of the committee, perhaps more than any other in history, actions by the Federal Government are obstructing the whole concept of partnership. I refer to the unprecedented rescission and deferral requests, the undermining impact of the Federal tax reform bill and proposals, the growing list of Federal mandates, and the intermediate actions of state governments.

The buck, after all, stops at the local level.

Most cities and towns are currently in the process of adopting new budgets. Most of us are nearly three-quarters of the way through our fiscal year 1986 budgets. Yet, the President's budget request—at least for municipal elected officials—has a much greater impact on current year municipal programs than 1987.

The combined fiscal year 1986 deferrals and rescissions cut priority municipal programs 35 percent this year; 64 percent of the rescissions are in our priority programs. The deferral in the Community Development Block Grant Program alone makes a 16-percent cut retroactive to last month. The concept of the Federal Government unveiling its 1986 budget in February of 1986 is truly extraordinary. The burden it creates as we try and balance our taxes and services at the local level is even more so.

The overall cut in priority municipal programs exceeds 57 percent and comes at a time when tax reform threatens to undercut our own authority and ability to raise our own taxes and capital. It is difficult enough to attempt to adjust to extraordinary cuts in vital programs three-quarters of the way through your budget year, but it is even more difficult when the status of your authority to borrow is threatened, and your ability to raise your own taxes is undercut.

The House tax bill has had the effect of law on municipalities since January 1 of this year. It has cut deeply into the ability of cities to issue bonds for the constructions of schools, hospitals, prisons, highways, and other public facilities adversely affected by the pending budget proposals.

In the Senate, renewed efforts are underway to repeal the deductibility of State and local taxes—an effort, which according to former Assistant Secretary Ron Pearlman, would reduce State and local tax revenues some 1 to 3 percent.

On the one hand, the budget seems to say the Federal Government no longer bears any role or responsibility—local governments and States can handle the job; while on the other hand, our traditional fiscal tools are being handcuffed.

It must be remembered too that as local elected officials, we must incorporate not only Federal tax and budget changes—at whatever hour—into our own budgets and tax rates, but also the actions of our respective State governments. In Iowa, for instance, the Governor has proposed across the board spending cuts to all local governments, and a freeze on property taxes.

Just since 1978, 31 State limitations have been imposed upon municipal revenue raising authority.

There has during this time, however, been no let up on Federal mandates. Despite tax and budget proposals which would have the effect of claiming that municipal wastewater sewage treatment plants are not "essential," this has in no way reduced the fines or penalties due to be assessed upon municipalities not in compliance with EPA's secondary treatment requirements.

The tax and spending cuts have not reduced the need for schools, prisons, hospitals, or highways—much less the standards of these facilities as set by the Federal Government and the judiciary.

A staff person from EPA questioned one of our staff last year why the NLC would oppose the new Federal regulations to require mandatory permits for every municipal stormwater discharge. My staff indicated that NLC was not necessarily opposed to the permit requirement, but that there seemed to be no consideration as to how these permits could be financed.

The official stated that since the Federal Government had a deficit and cities did not, the answer was obvious.

I would submit that that sort of attitude and thinking have been responsible for the growth of the Federal deficit from only $27 billion in 1979 to over $200 billion by 1985. Passing the buck to State and local governments is a measure of fiscal irresponsibility which has no place in a real partnership.

I am troubled, Mr. Chairman, by our Federal trade deficit, by our extraordinary level of children in poverty, by the increases in infant mortality.

For a nation which dreams of putting nuclear war in the heavens and has the resources to send a plane from here to Tokyo in 2 hours, surely we should have the commitment to make sure a black child born in Cleveland can have a life expectancy as long as a child born in Cuba. Surely, we can expect our public school system to produce the same educational opportunities as Japan. And surely, we should be able

to expect the commitment to rebuild our own highways and bridges so that industry can grow and build in this country, rather than overseas.

Our suggestions are simple. They have balance. If adopted, they would allow early, understandable action on deficit reduction, and would insure this Congress could act on other Federal legislation which has been allowed to lapse.

First, we believe that all Federal expenditures should be frozen, except for interest on the Federal debt and needs-tested entitlement programs.

This means that this committee would have to apply the same scrutiny to Federal tax expenditures as it does to other Federal expenditures.

We do not support a Federal tax increase. We do, however, believe that out of the $939 billion in new Federal revenues which would have been gained from former Treasury Secretary Don Regan's Federal tax reform proposal, at least a small fraction could be used for deficit reduction.

We do not believe the Nation can afford to pretend that tax reform and deficit reduction are unrelated, or separated by some Berlin Wall. With a projected Federal 1987 tax expenditure level exceeding $500 billion, a freeze alone would enable the Congress to comply with the Gramm-Rudman II target without any new tax or tax increase on the American people.

Finally, it seems to us that if the President, or the Congress, wish to increase spending—whether it be for defense, for foreign aid, for the Federal Aviation Administration, or for a new people's express to Tokyo—then they should ask for a Federal tax increase to pay for it.

If we really need to send our tax dollars to Guatemala—even though the president of that nation does not want them—then let the President seek a Federal tax increase to pay for it. Our people are sophisticated. They are able to make hard choices. Let them decide.

Had we proceeded on that basis over the last 6 years—a basis used by every State and municipality in our country—we might well not be in the serious fiscal and international trade straits in which we presently find ourselves.

Thank you for the opportunity to testify. I would be happy to respond to any questions.

The CHAIRMAN. Thank you, Mayor Cisneros, representing the National League of Cities.

Now we turn to the mayor who is representing the U.S. Conference of Mayors, Mayor Ernest Morial, from New Orleans, LA. I say that with a little pride, since I was born 90 miles up the road.

STATEMENT OF HON. ERNEST MORIAL, MAYOR OF NEW ORLEANS, LA, AND PRESIDENT, U.S. CONFERENCE OF MAYORS

Mr. MORIAL. Thank you very much, Mr. Chairman, and members of the House Budget Committee. On behalf of the U.S. Conference of Mayors, we are delighted to have this opportunity, and thank you for affording us the opportunity to express our views relative to the budget for 1987.

My colleague, Henry Cisneros, of the National League of Cities, has eloquently stated the case on the philosophical basis, the moral and ethical implications pertaining to this budget and as it relates to the aspirations of millions of Americans who live in the cities, the cities of America being the repository of the greatness of this Nation, the centers of culture, of commerce, the centers for education, for the totality of the life that makes America great.

I would like with your permission to deal with some degree of specificity on some of those programs.

First, General Revenues Sharing, which is of paramount importance to 39,000 local government units in this country, towns, and Indian tribes as well. We would strongly urge in the Conference of Mayors that full funding for this program at $4.6 billion be included in function 850 of the budget resolution. Without this vital source of funds which are allocated and appropriated by local gov-

ernments for a variety of services, programs such as provision for indigent children and senior citizens, health and human service programs, parks and recreation activities, and to cancel a wide range of programs if General Revenue Sharing is eliminated.

The result of the termination of the program would result in substantial tax increases at the local level, only in those jurisdictions where such is permissible. Local governments are under severe statutory constitutional limitations relative to tax increases. Wherever there is the property tax, there are limitations. Where there is a sales tax as a source of revenue for local government, referendum is required.

We are under constraints not comparable to any place else or any level of government in the United States. It causes a great impairment upon the ability of local governments to generate revenues.

There are some other Federal programs that should be considered. As Mayor Cisneros indicated, the Community Development Block Grant Program is of vital importance to the cities. I shall not dwell upon the importance of that, and shall move on to the issue of the Urban Development Action Grant Program, which allows for leveraging some $67 of private spending for each dollar of Federal money.

I think, Mr. Chairman, after your committee has been on the road as it has been, it would be unnecessary for me to elaborate on the great range and variety of projects that have been undertaken urban development action grants in cities across this Nation to stimulate jobs within the economy of those local governments and also to put on the tax rolls projects which stimulate and generate revenue for local governments to address those needs which only local governments can address.

The leveraging of private investment is also a very important element in the future for the Economic Development Administration programs. EDA has done much over the years to assist cities in providing the basic infrastructure necessary to economic and industrial development, creating investment, jobs, and income, and returning taxes to the Federal Treasury.

EDA has demonstrated over the years that small amounts of public money can leverage large amounts of private money, that business and Government can work together to strengthen the private sector in the public interest and provide income and revenue to both. EDA, even in its current reduced circumstances, is an institution eminently worth preserving.

The construction and upgrading of transportation facilities is just as much a component of economic development as direct development aid. The failure to build airport expansions and runways can prevent a city from attracting tourists, conventions, or large businesses. And the termination of Federal programs which support the construction or repair of streets and bridges can mean continued use of unsafe bridges, long commuting delays, and undermine efforts to attract new firms to the cities or get existing firms to expand there.

Moreover, affordable public transit has become very important, since low-income workers and the elderly have become increasingly dependent on buses, subways, van pools, dial-a-ride, and other pub-

licly subsidized forms of transportation. Cutting public transportation capital and operating subsidies will do the most harm to those least able to cope with the increased cost or find alternative means of transportation.

Wastewater treatment grants are also important in undergirding economic development efforts. We can't support a growing population or increased business investment without such infrastructure programs. Water, sewer, landfill, and solid waste facilities are one of the major constraints on growth of cities.

I know that the House Budget Committee is very sympathetic to and supportive of low-income programs—those Federal income programs that provide a "safety net" for the poorest of our citizens. But it is important to remember that some of those activities classified in the budget as aid to State and local governments are, in reality, programs that aid the poor. These programs were enacted and have been continued because the Federal Government has a commitment to serving these people and chose to do so by delivering the services through local governments.

In many surveys, citizens have consistently responded that the level of government they trust the most, where they are getting high-quality and efficient service, and where they can exert the most control is at the local level. Thus, it continues to make sense to deliver National Government aid by way of local government, where citizens and elected leaders can make sensible decisions on the ultimate use of Federal funds. Only local citizens know what road is in most need of repair, what neighborhoods need help, what types of private sector jobs should be stimulated, and where subsidized housing should be located.

The Conferences of Mayors recognizes the realities of the new Gramm-Rudman law. But the urban programs that we mayors think are important to save do not total anything close to the magnitude of budget savings that are needed to meet Gramm-Rudman targets. Eliminating all of them would hardly make a dent in the Federal deficit, but would wreak havoc at the local level.

City programs have been cut dramatically over the last 6 years. I am attaching to my testimony a table dramatizing the decline in the most important urban programs since fiscal year 1981. If the President's fiscal year 1987 budget were adopted, the total cut in urban programs would be 71 percent from fiscal years 1981–87 and 82 percent in constant dollars. Yet, while our programs have declined, the deficit has continued to escalate.

The deficit reductions called for by the Gramm-Rudman law are already being used as an excuse by this administration and others for wiping out all of our important social and urban programs and decades of progress in meeting human needs.

The Gramm-Rudman law does not bind the hands of Congress in the methods of achieving the required deficit reduction. Important urban and low-income programs—already cut significantly over the past few years—do not have to be cut further.

The Conference of Mayors believes there are other options for reducing the deficit. We continue to call for an across-the-board spending freeze and selective Federal tax increases as a way of reducing the deficit.

Moreover, it is always possible to make adjustments in the Gramm-Rudman law if the Congress in its wisdom sees a need to do so—to protect additional low-income programs from automatic cuts, to slow down the mandated deficit reductions, or to repeal the law entirely.

Thank you, Mr. Chairman, for this opportunity to present my views and the views of the U.S. Conference of Mayors on the fiscal year 1987 budget. I do not envy you your task of formulating a budget at a time when the deficit must be cut so significantly. The Conference of Mayors is willing to continue a dialog with you as you struggle to make budget adjustments and fashion a fiscal year 1987 budget that is sensitive to priority urban and low-income programs.

The CHAIRMAN. Thank you very much. Now we turn to Chuck Williams.

STATEMENT OF HON. CHUCK WILLIAMS, COMMISSIONER, FULTON COUNTY, GA, AND FOURTH VICE PRESIDENT, NATIONAL ASSOCIATION OF COUNTIES

Mr. CHUCK WILLIAMS. Good morning, Mr. Chairman, members of the committee. I am Chuck Williams, commissioner in Fulton County, Atlanta, GA, and fourth vice president of the National Association of Counties, the only organization in this country that specifically represents county government. I would like to thank you for this opportunity to respond to the 1987 budget proposals. In my testimony I would like first to give you a broad overview of our position on the budget and then highlight a few specific programs.

The Nation's county government officials support equitable efforts to reduce the Federal deficit. Counties have actively participated in developing solutions to the Nation's fiscal problems. Since the late 1970's, the National Association of Counties has supported cuts in certain Federal domestic assistance programs and has worked with Congress and the administration to share the burden in attempts to balance our national budget.

The 1987 budget proposal cuts deeply into programs that are vitally important to local government and particularly the low- and middle-income citizens in our communities. Increasing defense spending at a rate of 8 percent above inflation would be done at the expense of maintaining adequate public services. Our Nation's roads, education system, health care, environment—in short, the quality of life we enjoy—would be threatened if Congress accepts such draconian cuts.

We are playing a budgetary shell game, in the National Association of Counties' opinion. The President's proposal would shift national priorities, more than it resolves the Federal deficit. It continues a trend of Federal expenditures from 1980 through 1986 which, in real terms, increased defense spending over 45 percent while decreasing State and local programs 28 percent. In the 1987 budget the administration proposes that, for every taxpayer's dollar, only a dime will go back to State and local services, and 28 cents will go to defense. Because of this trend, the NACo Taxation and Finance Steering Committee for the first time will present to our total

membership this weekend in our legislative conference—a clear direction and a request that defense spending be restrained.

County governments have accepted more than their fair share of budget cuts. Large decreases in State and local grants has not served to decrease the Federal deficit.

As elected officials, we have the obligation to serve our constituents. Five years ago, the large majority of Americans did indeed support defense increases, but in 1986 they oppose them. The budget claims to reduce the deficit through cutting legitimate programs for the poor, yet 14 low-income programs totalling nearly $4 billion are proposed for elimination. Some of these programs are also included in a list of 13 programs scheduled for rescission, totalling over $6.9 billion.

I would like to highlight some programs of specific importance to NACo. Even though it has been referred to earlier, general revenue sharing is of critical importance to counties in this country. The reauthorization of general revenue sharing is NACo's top legislative priority. Besides requesting no authorization, the President proposes to rescind the entire October 1, 1986, fourth quarter payment.

General revenue sharing is an important part of the counties' budget. In Georgia, GRS represents over 8 percent of all taxes statewide. Of Georgia's 159 counties, 103 receive GRS funds that represent more than 10 percent of all local taxes, when you remove the taxes the school boards collect. Of these 103 counties, 79 will be severely impacted by the loss of GRS when local economic and potential revenue bases are considered.

GRS represents over 22 percent of the tax base. In Jasper City, in Representative Jenkins' home county of Perkins, GRS represents over 17 percent of taxes. In Fulton County, my home county, GRS pays for the entire $1.6 million share of our food stamp administration budget and 12 percent of our jail budget.

Our spending for human service resources programming is not unusual as it relates to that percentage of use. Nationwide, 62 percent of the counties NACo surveyed use it for health care and for social services, and this trend is increasing, to fill the gap in Federal cuts.

When asked, they tell us that the elimination of the program will mean higher taxes and, in some communities, reduced services for those having a declining tax base.

Gramm-Rudman overshadows much of our county and State finances. We have heard the argument that there is no revenue sharing to share, and yet fiscal planning services estimated to us that with Gramm-Rudman, in Georgia there will be a deficit of over $330 million. General Revenue Sharing is essential to fill those possibly huge gaps. Moreover, the cuts are hurting counties' ability to raise revenues through issuing bonds.

On another subject, the question of Medicaid, we know that health care is costly because 34 States hold county governments legally responsible for indigent health care. Capping or freezing the Federal contribution to Medicaid does not stop the caseload from growing.

The $1 billion in so-called savings in the 1987 budget is ultimately a cost shift to State and local governments. The uninsured sick

and injured continue to arrive at our public hospitals. At the county level we accept this responsibility, but we cannot do it alone. We need the commitment at the Federal and State levels to ensure access to minimum health care for all.

In rural programs, more than 2,500 of the more than 3,100 counties in the country have fewer than 50,000 residents. Many of these smaller counties rely heavily on farming, farm ancillary business as their chief economic base.

Rural local government revenues decrease as businesses fail. In the face of a dwindling tax base, rural communities cannot sustain the basic services of water, wastewater, and solid waste disposal. As a result, few options exist to expand the local economy to nonfarm industries.

The proposed immediate termination or phaseout of programs such as the Economic Development Administration, Appalachian Regional Commission, Rural Electrification Administration, and rural housing programs would exacerbate the economic problems of these rural areas.

On the environment and land question, the Wastewater Treatment Construction Grant Program is scheduled for elimination in 1990. The program is a valuable source of funding to help clean our Nation's water systems. Counties are building wastewater treatment plants and bringing sanitary landfills up to hazardous waste safety standards. But while the national goals, standards, and requirements remain, the Federal funding commitment to pursue these goals is being withdrawn.

In the employment and training services area, the administration is requesting that $462 million be rescinded from the 1986 appropriation and that $824 million be cut from the 1987 budget. These cuts are recommended in addition to the $285 million cuts scheduled to take effect as of March 1, as a result of Gramm-Rudman.

These programs provide vital services to the economically disadvantaged. Without these services, it will be difficult for these individuals to get the training they need to find employment. Cuts in JTPA will more than likely be offset by increases in participation in other Federal support programs such as Food Stamps, AFDC, and Unemployment Insurance.

In a number of our States in the country, county government is specifically required to provide human services. Despite the administration's position that programs such as Food Stamps and AFDC are not cut, their proposals in these two programs alone amount to a $592 million cut in the 1987 current services budget.

On top of this, are proposed eliminations of programs such as Emergency Food and Shelter for the homeless, the Community Services Block Grant Program, and the Low-Income Weatherization Program. Programs that have received the same funding over the last 5 years, such as Social Services Block Grant, in effect have been cut, in real dollars, at least 33 percent since 1980. We urge that these programs not be reduced further.

Mr. Chairman, we at the county level understand and realize that your committee has difficult decisions to make. We do ask that you take action which will enhance, not deteriorate the effec-

tiveness of local government. We ask that you not shift any more dollars from domestic to defense spending.

We thank you for this opportunity to discuss our position, and I would be pleased to answer any questions that you and other members of the committee might have. Thank you.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF HON. CHUCK WILLIAMS

Good morning Mr. Chairman and members of the committee, I am Chuck Williams, commissioner in Fulton County (Atlanta) and fourth vice president of the National Association of Counties. Thank you for the opportunity to respond to the 1987 budget proposals. In my testimony, I would like to first give you a broad overview of our position on the budget and then highlight a few specific programs.

The Nation's county government officials support equitable efforts to reduce the Federal deficit. Counties have actively participated in developing solutions to the nation's fiscal problems. Since the late 1970's, the National Association of Counties (NACo)[1] has supported cuts in certain Federal domestic assistance programs and has worked with Congress and the administration to share the burden in attempts to balance the national budget.

The President's 1987 budget again proposes to cut deeply into programs that are vitally important to local government and particularly the middle- and lower-income citizens of our communities. Increasing defense spending at a rate of 8 percent above inflation would be done at the expense of maintaining adequate public services. Our nation's roads, education systems, health care, environment—in short, the quality of life that we enjoy—would indeed be threatened if Congress accepts such draconian cuts.

We are playing a budgetary "shell game." The President's proposed budget further shifts national spending priorities more than it resolves the Federal deficit. It continues the trend of Federal expenditures from 1980–1986 which in real terms increased defense spending by over 45 percent while decreasing State and local program funding by 28 percent. In the 1987 budget, the administration proposes that for every taxpayer's dollar, only a dime will go back for State and local services, and defense will receive 28 cents. Because of this trend, the NACo Taxation and Finance Steering Committee, for the first time has urged the overall NACo membership to call for restraint in defense spending. Such a resolution will be considered at our legislative meeting this weekend.

County governments have accepted more than their fair share of budget cuts. The large decrease in State and local grants has not served to decrease the Federal deficit, as we had been led to believe. The deficit has continued to climb. As a percentage of the gross national product, the administration has presided over five of the six largest deficits since World War II. If measured in total dollars, by fiscal 1988, they will have presided over the seven largest deficits in our Nation's history, even if the Gramm-Rudman targets are met.

As elected officials, we must respond to our constituents. Five years ago, the large majority of Americans did indeed support defense increases. But in 1986, they oppose them. A recent poll commissioned by NACo had findings very similar to the February 14 Washington Post poll. In our poll, 62 percent said that Congress should not permit any further reductions in Federal local aid programs until there were meaningful reductions in defense. When placed in the context of reducing the Federal deficit, our results were nearly identical to the Post's. Thirty-three percent called for reductions in domestic programs (the Post had a 36 percent response) while 58 percent wanted defense cuts (the Post had a 56 percent response). Both polls also showed a strong opposition to raising individual income taxes to reduce the deficit.

The 1987 proposals do not reflect these opinions. The budget claims to reduce the deficit without cutting legitimate programs for the poor. Yet, 14 low-income programs totalling nearly $4 billion are proposed for elimination, ranging from the $504 million program in housing assistance for the elderly and handicapped, the $70

[1] The National Association of Counties is the only national organization representing county government in the United States. Through its membership, urban, suburban and rural counties join together to build effective, responsive county government. The goals of the organization are to: improve county government; serve as the national spokesman for county government; act as a liaison between the Nation's counties and other levels of government; achieve public understanding of the role of counties in the Federal system.

million emergency food and shelter program and the $354 million community services block grant. Some of these programs are also included in a list of 15 programs scheduled for rescissions totalling $6.9 billion in funds Congress already appropriated for fiscal 1986.

I would now like to highlight some programs of specific importance to NACo.

GENERAL REVENUE SHARING

Reauthorization of general revenue sharing is NACo's top priority. Besides requesting no authorization, the President proposes to rescind the entire October 1, 1986 fourth quarter payment.

General revenue sharing is an important part of county budgets. In Georgia, GRS represents 8.5 percent of all taxes statewide. Of Georgia's 159 counties, 103 receive GRS funds that represent more than 10 percent of all local taxes, when you remove the taxes school boards collect. Of these 103 counties, 79 will be severely impacted by the loss of GRS when local economic and potential revenue bases are considered.

In Quitman County, GRS represents 22.7 percent of its tax base. Jasper City, which is in Representative Jenkins home county of Perkins, GRS represents 17.3 percent of taxes.

In Fulton County, GRS pays for the entire $1.6 million share of our Food Stamp Program administrative costs. Twenty-five percent of our sheriffs budget and 12 percent of our budget for jails is funded by GRS. Our use of GRS for human resources programs is not unusual. Nationwide, 62 percent of the counties NACo surveyed use it for health care and social services, and this trend is increasing to fill in the gaps of Federal cuts. When asked, they tell us elimination of the program will mean higher taxes in some communities and reduced services in those having a declining tax base or which have reached their maximum tax levy under State law.

Gramm-Rudman overshadows much of our county and State finances. We have heard the argument that "there is no Federal revenue to share." Last summer Georgia indeed projected a small $38 million surplus for 1986. Yet, the Fiscal Planning Services, Inc. has recently estimated that the possible fiscal 1987 Gramm-Rudman cuts in combination with the loss of GRS would leave Georgia with a deficit of over $330 million. General revenue sharing is essential to fill in those possibly huge gaps. Moreover, the cuts are hurting counties' ability to raise revenue through issuing bonds.

MEDICAID

We know that health care is costly because 34 States hold county governments legally responsible for indigent health care. Capping or freezing the Federal contribution to medicaid does not stop the caseloads from growing. The $1 billion in so-called savings in the 1987 budget is ultimately a cost shift to State and local governments. The uninsured sick and injured continue to arrive at our public hospitals. At the county level, we accept this responsibility, but we cannot do it alone. We need the commitment at the Federal and State levels to insure access to minimum health care for all.

MASS TRANSIT

The budget includes a $2.6 billion cut in mass transit, with the remaining $1.1 billion in Federal funding coming from the 1-cent gasoline tax. This $1.1 billion will be merged with $2.2 billion from the highway program to form a block grant, none of which can be used for transit operating assistance, a form of assistance essential to counties. When placed in the context of the proposal to build a multibillion dollar space plane that will fly us from Washington to Tokyo, we again find that savings are not realized—the budget has been shifted.

CDBG/UDAG

The Community Development Block Grant (CDBG) and the Urban Development Action Grant (UDAG) face severe reductions, with UDAG proposed for termination and CDBG receiving a 32 percent reduction within the past year.

CDBG is the cornerstone urban development tool used by local governments for housing rehabilitation, public facilities construction and job creation.

In its 12-year existence, the program has attracted substantial private reinvestment to local communities, making it an extremely effective and popular program to urban and rural counties. Like general revenue sharing, CDBG provides flexible use of funding for necessary community projects and services. We cannot accept another cut in this program.

RURAL PROGRAMS

More than 2,500 of the Nation's 3,100 counties have fewer than 50,000 residents. Many of these small counties rely heavily on farming and farm ancillary business as their chief economic base.

Rural local government revenues decrease as business fail. In the face of a dwindling tax base, rural communities cannot sustain the basic services of water, wastewater and solid waste disposal. As a result, few options exist to expand the local economy to nonfarm industries. The proposed immediate termination or phase-out of programs such as the Economic Development Administration, Appalachian Regional Commission, Rural Electrification Administration and Rural Housing Programs would exacerbate the economic problems of these areas.

JUSTICE PROGRAMS

During the mid 1970's when the Law Enforcement Assistance Administration (LEAA) existed, over 40 percent of the Justice Department's budget went directly to State and local governments for justice programs. Today with LEAA long gone, the Justice Department's budget has continued to rise, although now counties, States and other local governmental units receive less than 5 percent of the department's overall budget. Last month OMB approved a rescission request which threatens all remaining State and local initiatives, including the Juvenile Justice, Justice Assistance and Victim Assistance Act programs. This action again raises questions about the nature of the Federal, State and local partnership.

ENVIRONMENT AND LAND ISSUES

The Wastewater Treatment Construction Grant Program is scheduled for elimination by 1990. The program is a valuable source of funding to help clean our Nation's water systems. Counties are continuing to build wastewater treatment plants, resource recovery operations, and bring sanitary landfills up to hazardous waste safety standards. But while the national goals, standards, and requirements remain, the Federal funding commitment to pursue these goals is being withdrawn.

Of concern primarily to western counties is the proposal to change the way in which they receive money from forest receipts. Under the proposal, rather than receiving a percentage of the gross receipts, States and counties would receive the money only after the Federal Government skims off the top. If legislation is approved, State and local payments will be cut $225 million, from estimated 1987 receipts of $310 million down to $85 million.

EMPLOYMENT AND TRAINING

In the employment and training services area, the administration is requesting that $462 million be rescinded from the 1986 appropriation and that $824 million be cut from the 1987 budget. These cuts are recommended in addition to the $285 million cut scheduled to take effect on March 1 as a result of the Gramm-Rudman Balanced Budget Act.

Many programs in this area have suffered drastic cuts since 1981. The Job Training Partnership Act (JTPA) and the Work Incentive (WIN) Programs just last year were cut by $288 million (8%) and $47 million (18%) respectively. Despite the $159 million (4.3%) cut imposed by Gramm-Rudman, the administration is requesting that an additional $416 million (12%) be rescinded from JTPA and $46 million (21%) from WIN in 1986. Moreover, it has requested a $577 million reduction in JTPA for 1987 and the total elimination of WIN.

These programs provide vital services to the economically disadvantaged. Without these services, it will be difficult for these individuals to get the training they need to find employment. Cuts in JTPA and WIN will more than likely be offset by increases in participation in other Federal support programs such as food stamps, AFDC and unemployment insurance.

HUMAN SERVICES

Despite the administration's position that programs such as food stamps and AFDC are not cut, their proposals in these two programs alone amount to a $592 million cut in the 1987 current services budget. On top of this are proposed eliminations of programs such as Emergency Food and Shelter for the homeless, the Community Services Block Grant and Low Income Weatherization, to name a few. Programs that have received the same funding over the past 5 years such as the Social

Services Block Grant in effect have been cut in real dollars by at least 33 percent since 1980. We urge that these programs are not reduced further.

Mr. Chairman, we realize your committee has difficult decisions to make. We do ask that you take actions which will enhance, not deteriorate the effectiveness of local government. We ask that you not shift any more dollars from domestic to defense spending. Thank you for the opportunity to discuss our positions with you. I would be pleased to answer any questions you may have.

The CHAIRMAN. Thank you very much, Commissioner Williams.

Now we will turn to the spokesperson for the National Conference of State Legislatures, Delegate Lucille Maurer, of Maryland. Welcome.

STATEMENT OF HON. LUCILLE MAURER, MARYLAND STATE DELEGATE ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Ms. MAURER. Thank you, Mr. Chairman, and members of the Budget Committee. My name is Lucille Maurer. I serve in the Maryland State House of Delegates as the chair of the Joint Committee on Federal Relations. It is a great pleasure to be here on behalf of the National Conference of State Legislatures, which, as you know, is the voice of the Nation's 7,500 State legislators across the country in our 50 States.

I do not have to tell you that this February is different from preceding Februarys, and that is because of Gramm-Rudman-Hollings and the pressures that you are under to solve the problems of meeting deficit reductions and trying to preserve us as a Nation and as a people.

I would say that the difficulty you face is also a necessity and an urgency, and as partners in the Federal system we are willing to share in a fair and equitable way. But such reductions must be used to reduce the deficit and to reach the target, and we believe that it will be impossible to reach those targets solely by cutting domestic programs; that is, our State and local programs and the programs for the citizens of our respective States.

A little bit of history might be a useful tool in this regard. Since 1978 that portion of the budget supporting grant-in-aid programs to State and local governments has dropped dramatically. Using the Historical Tables document published by the administration, we see the shift, the dramatic shift, in Federal support. In 1978, grants amounted to 17 percent of Federal outlays. By 1991, under the President's budget estimate, grants will be at 9 percent of outlays. However, this does not truly reflect what has been happening over time. If adjusted for inflation, grants will fall over 32 percent. And we can take this one step more. If you exclude payments that are actually made to individuals through State and local government, the decrease is astounding. Grants go from $76 billion in 1978 to $31 billion in 1991, down from 11 percent of outlays 13 years earlier. Nevertheless, during the time period from 1978 to 1985, the percent of Federal debt held by the public rose from 28 to 38 percent.

Having said that the States are willing to share in the agony, do not think that we have absorbed the cuts of the past few years without our own tough, politically tough, decisions. States have raised taxes. We have alternately pruned, consolidated, tightened, or eliminated programs.

States are required to have balanced budgets. We do not have deficit financing mechanisms for operating expenses, and we have to go to the bond market for capital funds, and credit ratings make it imperative to sustain certain balances. In fact, the so-called surpluses of 1, 2, or 3 percent of expenditures fall far below the prudent standard of closer to 5 percent.

The aggregate surpluses that are bandied about as the reason States can absorb large cuts, are concentrated in a few States, and some of those surpluses may be greatly diminished by such changes as the change in the oil price.

That brings me to another point, and that is the marked variation in the condition of State economies. The States which are heavily oriented to agriculture, such as the prairie States, are obviously adversely impacted by the farm problems. The energy-producing States are adversely affected by the oil glut. States such as Oklahoma have economies based both on agriculture and energy.

We urge you to think about the impact of your decisions in the Federal budget in terms of the different State economies, not just in terms of aggregate statistics. And even so, the so-called vast surplus is illusory and misleading. The hard realities are the tough decisions to reach balanced budgets in our States and the general condition of the economy masks some of the great variations among the States.

I would like to turn for a moment to our relationships with the units of local governments within our States, to the counties, the cities from whom you have heard.

When the Federal Government makes drastic changes in its relationship to local governments, obviously State governments will have to review State-local fiscal relationships. State governments are becoming, in short, a fulcrum, pressed to meet State program needs but also having to deal with the needs of local governments.

Our national conference president, Senator Nething of North Dakota, has appointed an internal State-local task force, which is charged with finding new ways to meet the demands of today's society, especially in light of the fiscal position of the Federal Government.

I would also mention our concern, our ongoing concern, with Federal mandates. As funding vanishes, responsibilities remain, and we may need some relief. NCSL is presently working with Senator Dole, at his request, in delineating just what mandates our members have the most trouble with at the State level, and we would welcome a similar opportunity to work with the House.

I would now also turn to our revenue-raising capacity. It has been mentioned earlier. We recognize that you are not a tax-writing committee. On the other hand, you cannot deal with the budget in a vacuum. I feel it is urgent that we mention the undercutting of State revenue-raising capacity by the tax reform bill now pending in the Senate. We at NCSL were grateful to the House for saving State and local tax deductibility. We continue to think this is crucial for us to deal with the consequences of budget cuts.

On the other hand, we are also concerned by the limitations on tax-exempt bonds which impair our critical capital projects. The issue of State and local tax deductibility is apparently going to be revisited in Senate consideration, and we are going to work dili-

gently to preserve the House position, and we will also work diligently to remove some of the limitation on tax-exempt bonds.

But again, I want to emphasize that budget action cannot be taken in a vacuum. But in the larger sense, as has also been mentioned, we are not only looking at a budget, we are looking at what kind of a nation and what kind of a people we will be.

We are looking at federalism, the fundamental arrangement under which this Nation has grown and prospered as a democracy. We have provided hope and help to our citizens. These are key policy choices that you will be making, not numbers in a vacuum. We are concerned that inevitably the budget will drive what becomes of federalism and will be done perhaps in an ad hoc way unless there is a consensus developed on who should do what and who should pay for what, and for which services.

Sorting out is the shorthand I think we all use for the discussion of the roles of the partners in our Federal system. NCSL is very sensitive to the underlying policy questions and urges caution in making budgetary decisions that might hamper or preclude a broad sorting-out consensus from developing.

In turning to an example of some of our more specific concerns, and talking of an example of health care and how it affects our citizens, NCSL has been concerned with the administration's Medicaid proposal in the budget because this is of such urgency in dealing with our health care costs.

In our State, we are one of the leading States in containing health care costs. But nevertheless, in the projections that have been made, we would lose, I think, in the order of $76 million through the capping proposal.

In summary, we recognize the delicacy and the urgency of the task before you. We believe that the problem of reaching the deficit targets cannot and must not rest solely on cuts on the domestic programs. We emphasize the importance of protecting State and local revenue-raising capacities, and we will be glad to assist in any way we can in participating in a dialog on mandates, on sorting out, and we urge you, as a final caution, consider the great variation in State economies and in the great need of States to balance their own budgets and to maintain minimum balances. We believe in deficit reduction and are eager to be a partner, but we cannot be a sitting duck. Thank you.

[The prepared statement of Ms. Maurer follows:]

PREPARED STATEMENT OF HON. LUCILLE MAURER

Thank you Mr. Chairman and members of the committee. My name is Lucille Maurer. I serve in the Maryland State House of Delegates as the Chair of the Joint Committee on Federal Relations. It is my pleasure to join you today on behalf of the National Conference of State Legislatures. NCSL, as you know, is the voice of Nation's 7500 State legislators.

I am sure I do not have to tell any of you that this February is different from all preceding February's. As the budget process begins here in Congress, it is enveloped in the shadow of something never before present in the Federal budget debate. Of course you know that I am referring to the "Balanced Budget and Emergency Deficit Control Act of 1985" or the Gramm-Rudman-Hollings amendment. The Federal district court decision notwithstanding, Congress has never been placed in such a pressure-packed situation as it finds itself in now. Believe me, ladies and gentlemen of the committee, as a fellow elected official I know a lot about the tough position you are in.

We recognize not only the difficulty you face but the necessity and urgency of deficit reduction. We are willing to contribute to your efforts to reduce the deficit. State governments will be a participant in equitable reductions in Federal spending for the purpose of deficit reduction. As partners in the Federal system, we are willing to share in a fair and equitable way, in the efforts to reduce the deficit, but such reductions must be used to reduce the deficit. Furthermore, as I will describe in more detail, the deficit targets cannot be met by cutting only the domestic programs, i.e. State and local government and the programs for the citizens of our respective states. A little bit of history might be a useful tool in this regard. Since 1978 that portion of the budget supporting grant-in-aid programs to State and local governments has dropped dramatically. Using the "historical tables" document published by the administration, we see a dramatic shift in Federal support. In 1978 grants amounted to $78 billion or 17 percent of Federal outlays. By 1991, under the President's budget estimates, grants will be $102 billion, or 9 percent of outlays. However, this does not truly reflect what is happening over time. If adjusted for inflation, grants will fall from $110 to $74 billion, a drop-off of over 32 percent. Let us take this point one step further. If you exclude payments that are actually made to individuals through state and local governments, the decrease is astounding. Grants go from $76 billion in 1978 to $31 billion in 1991, or 3.9 percent of outlays, down from 11 percent 13 years earlier. Nevertheless, during the time period from 1978 to 1985, the percent of Federal debt held by the public rose from 28 to 38 percent.

Members of the committee, I ask that you put yourselves in the position of State legislators for a moment. Being told year after year that many key programs must be reduced in the name of deficit reduction begins to lose its impact when those reductions seem to be devoted to other areas of spending, rather than deficit. In light of this past record, we find the rationale difficult to hold to. It is for this reason that NCSL believes that any aid reductions must be applied to reductions in the deficit.

Having said States are willing to share in the agony, please do not think we have absorbed the cuts of the past few years without our own politically tough decisions. States have raised taxes. We have alternately pruned, consolidated, tightened, or eliminated programs. States are required to have balanced budgets. We do not have deficit-financing mechanisms for operating expenses. We have to go to the bond market for capital funds and credit ratings make it imperative to sustain certain balances. Most States, in fact, have so-called "surpluses" of 1 and 2% of expenditures which fall below the prudent standard of closer to 5 percent. The aggregate balances that are bandied about as the reason States can absorb large cuts are concentrated in a few States, and these balances may be greatly diminished by such changes as the drop in oil prices.

Which brings me to another point—the marked variation in the condition of State economies. The States which are heavily oriented to agriculture have been adversely impacted by the farm problems. The energy producing States are adversely impacted by the oil glut. States such as Oklahoma have economies based on both agriculture and energy. We urge you to think about the impact of your decisions on the Federal budget in terms of different State economies, not just in terms of aggregate statistics. The so-called vast surplus is illusory and misleading. The hard realities show considerable variation among the States.

NCSL is continually confronted with the estimates of end-of-year budget balances. I am sure our local government partners have the same problem. The budget balance estimates are now being used against us. Our actions to cut spending and raise revenues, and act fiscally responsible, are now being used as an excuse to cut Federal spending. The fact that the bulk of budget balances are held in a handful of States, or that balances are a small percentage of State expenditures are conveniently ignored.

What is more, the relative position of State budgets should probably play no substantive role in policymaking at the Federal level. As I mentioned, NCSL is very interested in discussing proper roles of government and maintenance of our Federal system. For activities that the administration and Congress have voted to support as "Federal" responsibilities, why are we discussing State budget balances? If an activity is properly a Federal activity, of what relevance is State fiscal health? We are more than willing to sort things out, but please do not use our prudent actions of the past to justify a reduction in commitment to Federal activities.

And within each State we have differing relationships with our units of local governments; whether they are counties or cities. When the Federal Government makes drastic changes in its relationship to local governments, obviously State governments will have to review State-local fiscal relationships. State governments will, in short, become a fulcrum—pressed to meet State programs but also having to deal

with the needs of local government. Our NCSL president has appointed an internal State-local task force which is charged with finding new ways to meet the demands of today's society, especially in light of the fiscal position of the Federal Government.

In this connection, one ongoing concern of the States relates to Federal mandates. As funding vanishes, responsibilities remain and we may need relief. NCSL is presently working with Senator Dole, at his request, in delineating just what mandates our members have the most trouble with at the State level. An offer similar to this from the House would be welcomed by NCSL.

Also, let me mention one item not directly related to this committee. While the Budget Committee technically does not deal with tax writing, I feel it is urgent that I mention the potential undercutting of State revenue raising capacity by the tax reform bill now pending in the Senate. NCSL is grateful to the House for saving State and local tax deductibility. We continue to think this is a crucial facet in helping us deal with the consequences of budget cuts. We are disturbed that the Senate has been asked to revisit the issue. On the other hand we are also concerned by the limitations on tax-exempt bonds, which also hamper our capital projects. We will work diligently to remove some of the restrictions. The point here is that budget action must not be taken in a vacuum.

In the larger sense we are not only looking at a budget. We are looking at federalism—the fundamental arrangement under which this Nation has grown and prospered as a democracy. These are key policy choices, not just numbers in a budget. We are concerned that inevitably the deficit will drive what becomes of federalism in an ad hoc way unless there is consensus developed on who should do what and who pays for which services—sorting out is the shorthand for discussion of roles of the partners in our Federal system. NCSL is very sensitive to the underlying policy questions and urges caution in making budgetary decisions that will hamper or preclude a broad sorting-out consensus.

A couple of important items seem to conflict with the deficit rumblings that we have heard for so long. Certain recent reports indicate that without significant action being taken the deficit is now on a downward path. Well, this is good news. Unfortunately, the fine print accompanying those estimates raises questions in my mind. If you really believe that no real growth in defense spending for 5 consecutive years is a possibility, perhaps those estimates are realistic. Those of you in the Congress are much closer to those decisions. If you do not agree with CBO's baseline assumption, some concerns need to be raised. These new baselines combined with the actual amount of defense outlays for 1987, causes those of us in the State-local community to be quite wary in working on our own budgets. We are now being asked to assume new activities or go without to assist in reducing the deficit. If that transpires and we then find the August budget updates calling for more deficit reduction, we will be forced to look on these proceedings with some degree of skepticism.

Members of the committee, I have talked about State and local grants, cooperation, and the deficit. We support the basic thrust behind the Gramm-Rudman-Hollings amendment or the Gramm-Rudman-Hollings-Mack amendment as I have heard it referred to. The deficit needs to decrease. As we see it, Gramm-Rudman-Hollings has provided an incentive to the Congress to make progress on the deficit. Whether it needs to decrease in $36 billion increments or by some other amount, I do not know. I do know that $2 trillion of debt should not be tolerated.

I feel that I should mention just one more item in the State-local agenda. Our NCSL Federal Budget Committee has chosen to take a tough line in our Federal spending position. As I mentioned, we would like to work with you, and not complain to you. One of the items that our committee decided to mention is a need for sufficient funding for certain programs assisting the less well-off in our society. To bring this to proper attention, let me use some projections from our affiliate organization, Federal funds information for States. The administration's Medicaid proposal is one that is particularly troublesome to me. Our estimates show that the "cap" would cost my State of Maryland $76 million as compared to current services. Other States would be effected similarly: Pennsylvania by $77 million; Ohio $336 million; and Texas $177 million. This is a fitting example of how our relative stable position in the aggregate is not being understood. The Federal support of income security and health for our population is being withdrawn. The response in my State would not be joyful. The status of State rainy day funds or ending balances is very precarious compared to the amount of Federal responsibilities we would be faced with assuming. End-of-year budget balances of 3 percent will not stand up very long with budget authority reductions of the magnitude that are being discussed in Washington. There is a serious question of which Federal programs will be assumed by State

governments and which programs will not. For those programs that are not assumed, I trust it will be made clear that the reason for service reductions or terminations are due to policy choices made at the national level.

Thank you for your time today. I appreciate the opportunity to testify before you. I wish you luck in your deliberations. Keep in mind that we are part of the Federal system and want to work with you, if given the chance.

The CHAIRMAN. Thank you very much. I want to thank the witnesses for their testimony. I realize the sacrifice that all of you are making as very important elected officials in our Nation, to come and share with us this morning.

I want to ask one question, and I would like a response from each one of you.

Last night, the President went on national television to urge America to support the military buildup of 12-percent growth and at the same time support his budget. There are television ads running all over the country saying, "support the President's budget." That means supporting not only the goal of deficit reduction, which I think we all share, but also his priorities. These would be a 12-percent growth in Pentagon spending, an elimination of over 40 domestic programs, and a very significant reductions in other domestic programs in order to finance the military buildup.

Could you give me what your best estimate is of the constituents you represent, what their feeling is about the President's budget? Do they support the choices that the President has made?

Could I start with this end, Mr. Williams, if you could just give me a very abbreviated answer based on your constituency.

Mr. CHUCK WILLIAMS. Yes, Mr. Chairman. I find it interesting that late last year, the National Association of Counties commissioned a poll of the citizenry of the country for what their feelings were relative to the budget. We found that the responses that we got were consistent with the responses that are found in the February 14, 1986, Washington Post poll where 62 percent of the persons who responded were supportive of a restraint in defense spending. We believe that situation is the same with the National Association of Counties or the constituency group that I represent this morning.

As I said as a part of my testimony, for the first time in the history of the National Association of Counties, our Taxation and Finance Steering Committee will be recommending to the entire leadership and to the entire membership of NACo, as a part of our legislative conference which begins on Friday, that we issue a public policy statement on the question of restraint in defense spending.

The CHAIRMAN. Mayor Morial, based on your knowledge of your constituents in the community of New Orleans, as well as the bipartisan organization you represent.

Mr. MORIAL. Thank you very much, Mr. Chairman.

As you know, the U.S. Conference of Mayors represents cities of 30,000 population and above, and as you have indicated, it is a bipartisan group. That bipartisan organization, the U.S. Conference of Mayors, has repeatedly stated its position in opposition to the continued growth in the defense budget as against adequate funding for domestic programs. We have repeatedly restated our policy position that there should be a freeze on all spending and that

there should be some tax increases, though that is not within the province of this committee, but we have repeatedly stated our position on those issues, and we certainly—the consensus, a bipartisan consensus, within the U.S. Conference of Mayors would reflect that there is strong opposition to the President's position, relative to substantial increases in defense spending.

The CHAIRMAN. Mayor Cisneros, how do your people feel about the choices that the President made in his deficit reduction package?

Mr. CISNEROS. I would answer you this way, sir. The people of San Antonio, the people of Texas, and, I think, the American people are practical people. And though they may want everything, they know that, just as in their family budgets, it is impossible to have everything. It is impossible to raise defense by 12 percent, to hold harmless all the entitlement programs, to pledge oneself to no tax increases or new revenues whatsoever, and then to try to balance the budget on the backs of some 25 percent left of the programs and still build a country. You can't do it. It's not possible. It's not practical.

So being practical people, I think what the people probably would think in my city is that everyone ought to take a part of the sacrifice. The cities will be cut back some, but it's not possible to grow at 12 percent in defense, and there's going to have to be some revenues at some point in the mix, and my assessment would be that this is the time for some compromise, some dialog, some consensus, but that that package, as it stands now, is not good for the country in the long run, that we have to have something left to defend, and that means investing in education, investing in the future of the country as well as in some particular weapons systems.

The CHAIRMAN. Thank you very much, Mayor. I'm glad to hear you say very clearly that the mayors do expect and the cities do expect some reductions, but they want equity.

Mr. CISNEROS. And we have. We have suffered some reductions, and there will be more, but there needs to be equity across the board.

Ms. MAURER. Yes, Mr. Chairman, obviously the 7,500 legislators are made up of people from both parties. I think I tried to indicate in my earlier statement that we recognize that it is impossible to increase the defense budget as proposed, to insist upon no revenue increase, increases from new sources, and balance the budget on the domestic programs. We cannot see how you can have fair and equitable reduction and sustain urgently needed programs by requiring all the cuts essentially to come from the domestic side of the budget.

The CHAIRMAN. Thank you very much. The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. I would like to yield to the gentlelady who fights like heck for revenue sharing.

Mrs. BOXER. Thank you very much. I have no questions because I know the schedule of the committee, and I have to run to the House floor.

I only wanted to thank these witnesses very much for saying things that are certainly music to my ears as a local government

official for 6 years in California and as a human being. Quite frankly, I think you are addressing those issues.

We are really in a battle for the hearts and minds of the American people, and I think that our chairman alluded to that when he talked about the President going on television. All of us can't do that.

You have the ability certainly, as we do, to some limited degree, to go to the American people in your areas. I would only tell you, this budget has a certain symmetry. It's very clear. A $30 billion increase in defense, a $29 billion decrease in domestic programs. Those are the latest CBO estimates. I want to put them in the record. The President has not been honest with the American people. He's talked about a $16 billion increase in defense and a $22 billion cut in domestic. It's a lot worse than that, and we are going to need you to go to the American people with us.

And thank you, Mr. Chairman.

The CHAIRMAN. I want to thank the gentlewoman from California, Mrs. Boxer.

The gentleman from Washington, Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman. I want to thank the panel for excellent testimony.

As you know, we in our budgets have many times frozen the pay of the Federal employees, something that I think is very unfair, but as you probably know, that's been a fact. And I think everything that each of you has said makes total sense.

A problem I have had in this Federal budget is where we freeze the pay, and on the domestic side even worse than that, of our Federal employees and struggle to get meager amounts of money to the cities and the local governments, and then there will be pay raises for the employees on the local level.

I'm for pay raises for Congressmen and for local employees, OK, so I don't want that taken wrong. But the question I want to ask is, in this really tough time, to be able to get money for the CDBG for the reasons that were said and for the revenue sharing for the reasons that were said, that those are the poorest of the poor, and you're on the frontline—well, we know that those dollars are really going to go into those programs that address those problems of the people who can least—who need the opportunity, or are we going to be passing money down for pay raises for local employees while we freeze Federals?

Obviously, any of you.

Mr. CISNEROS. Congressman, I'll take a stab at it and then Mayor Morial.

Let me just say that the first question I would ask in return is, who are the employees of local governments? The biggest proportion of the employment in local government are people who collect the garbage and people who perform custodial services, people who walk through the parks in order to maintain the parks, and those people are near poverty level wages.

We have frozen in the last years from time to time their salaries as well, but the rate of the increases we've given have been 3 percent, when we've given them, so it's hardly as if there were some people sort of riding the backs of some great, you know, sort of gravy train. It's just not the case.

We do have to remain competitive in fire and police wages, but they're not highly paid people either in many places. And then, of course, those who we fund with such things as revenue sharing and CDBG that perform social services, they're not covered by Davis-Bacon wages, so in many instances we're talking about people doing day care at near minimum wage or below levels.

So my answer would be, I don't think there is a realistic prospect of using Federal dollars through revenue sharing, CDBG, or others to basically spend it in wages. That's not the dynamic that I know in cities.

Mr. LOWRY. We are out of time. The point of my question was, we have an equity problem.

The CHAIRMAN. The gentleman from Montana, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

We are wondering, of course, whether or not the American people want to accept the President's budget as is. We've been around the country trying to find out. Now you people have been good enough to come here. And as I translate your answer, you're saying, "No, Ronald Reagan is wrong. He has his priorities wrong," and you would like this committee to change things.

I am not sure what we can do about our joint difficulties in the short run.

Let me use my time to make a statement to you about the problem in the long run. It seems to me that we have a deficit that is as important in the long run as the Federal deficit, and that is a friendship deficit between us. Let me be frank with you, although I am not pointing fingers because I don't see any of you doing this what I am about to complain about.

It has been politically fashionable for Governors and mayors, particularly Governors and mayors in the West where I come from, to denigrate the Federal Government, denigrate us with one hand while with the other hand reaching out for more money. Throughout all of the last 50 years, with the exception of the last 10 or 15 years, there has been a very good working partnership between the Federal Government, the State governments, local governments, and even the school districts.

But lately, too many local and State officials, including Governors and legislators, have denigrated this Federal Government, referring to it as Disneyland East and the Puzzle Palace, and frankly, they have made it easy for someone like Ronald Reagan to come along and be widely accepted.

The Governors were in town the other day, and one of them said to Ronald Reagan, "You know, Mr. President, the Federal Government has made our job the best in the world, second only to your own." And that is true.

I'm from the West. The West has many Governors and many mayors who get elected while denigrating the Federal Government. They point to the fact that they can get elected as Democrats. Why can't national Democrats get elected? That is because you cut the ribbons, and we get to raise the taxes or catch heat for the deficit.

I'm from Montana. I know why our Governor, the Governor of New Mexico, the Governor of Colorado, and the Governor here in Virginia are popular. Because they are still operating on programs

that came from the New Deal, the Great Society, and the New Frontier.

In Montana, I know where the dams came from, the highways, the sewer systems, the irrigation projects, the Federal buildings, and, yes, the courthouses. I know where Head Start and the Peace Corps came from.

And so what I'm saying to you—as important local, county, and State elected officials is, we now have to stop doing what is politically fashionable, and that is denigrating each other. In the end this makes it very, very difficult for us to provide you with the assistance that you want, when you take the assistance and then turn around and criticize us because taxes are too high or there is a budget deficit or there are regulations that went with the assistance.

We have got to do a better job of working together. Otherwise, we make it easy for people to act as demagogs and as such, get elected to high office.

Mr. LOWRY [presiding]. Welcome, Mayor Koch, your statement will be entered into the record, and if you would like to join with us in the answers to the questions and so on. I'm sorry about your plane being late. As you know, we have been cutting the FAA quite a bit lately. Mr. Fazio.

Mr. FAZIO. I'm going to be very brief. There are other people who have not had a chance, and we will not get to hear them all if we're not brief.

I just want to say, the tragedy of this hearing is that you are preaching to the choir. The people on this side of the aisle are the ones who are present today. I don't even see a staff person from the other side, and, of course, that is where the arguments need to fall on receptive, not deaf, ears.

We are sitting here with data in front of us that shows that on major urban programs, we have reduced spending in absolute terms from $59.7 billion in 1981 to $17.4 billion in 1987, and those dollars, even though they are reduced absolutely, are also buying 35 percent less for the local governments that want to expend them.

I am also aware of the fact that in many areas, because of the proximity that you have to the voters, there are State and local tax limitations in effect, limitations on spending. My State of California is now bound by both at the State and local level. They can't raise revenues to compensate for reductions in programs that we're cutting here.

Thus, we all are in this very leaky boat together. I just want to simply say that as we try to improve urban program budgets and attempt to balance some of the mispriorities of this administration, we have to look to programs that target you and not throw money to local government or State government in general. And that may be implied as a slight criticism of revenue sharing.

In my communities, with proposition 13 and proposition 4, I know that that money is going into police and fire and fundamental services. So I don't feel good about making my case. But as I look at our opportunities to add back, I want to put money into programs that go to the poorest communities, the center city communities, the places in rural America that need it, and not simply

give it to every community, regardless of their tax base or ability to pay for services.

Thank you, Mr. Chairman.

Mr. LOWRY. Thank you. Mr. Jenkins.

Mr. JENKINS. Thank you, Mr. Chairman.

First of all, I want to welcome Commissioner Chuck Williams, who does a great job in my home State and in Fulton County, and I appreciate your testimony very much and the entire panel.

I do not intend to ask any questions, but like my good friend, Vic Fazio, I must say that we have to be realistic and pragmatic, as the mayor, just indicated, and our situation is simply this. We are going to get a budget resolution out of the House that, hopefully, will be a reasonable budget resolution. We will establish priorities, and in my view, we will not have the defense increase that is sought by the administration, but we will have a budget that will call for some reductions. There is no other alternative.

As we look at the situation realistically, with the administration totally opposed to any increase in revenues at this point, we are forced to rely upon the spending side for reducing the deficit. And as all of us know, the President is extremely persuasive, extremely popular. When one carries 49 out of the 50 States, the great majority of the people within each of your States gave a strong vote of support for this President and his policies, and his policies were no secret 2 or 3 years ago. They were well-known.

So while we may not like them, we, as a legislative body on the Democratic side, must work within the constraints that we have. We intend to change the budget. Obviously the House will get a chance to vote on the President's budget. I would think that it will be rejected from both sides of the aisle, and then we will be forced to try to come up with a budget resolution, possibly without revenues, simply because we cannot overcome any veto.

I thank the entire panel for your testimony, and, Mayor Koch, it is always good to see you back.

The mayor got here a little late but it is always good to have you, Mr. Mayor, late or not, and I will defer my questions so you may be able to make a statement and join in with the rest of the panel.

STATEMENT OF HON. EDWARD KOCH, MAYOR OF NEW YORK CITY

Mr. KOCH. Mr. Chairman and members of the committee, I do not want to go over old ground and if I mention something that has been mentioned, let me know and I will stop. I will not read my speech. I will just highlight some of the things that I think are important.

Having served here for 9 years, I know how important the Congress is, and in particular, the House of Representatives. I know how difficult your job is and at the same time I have some insight into it, so I want to address this issue of what the President does not want and what the President can veto but the President cannot pass legislation without your concurrence. He can veto but that does not mean that which is left is something he can impose.

Therefore, the Congress ultimately, even if it is not able to work its entire will, neither can the President, and a compromise could be achieved even if there were to be a veto, and maybe there would not be, because that which is being proposed makes sense.

Let me tell you what I think most people believe. I have had many town hall meetings in New York City. I always talk to people and I say to them, if you have a choice between a reduction in services, which would follow a reduction in taxes, Federal taxes, as opposed to either maintenance of service or enhancement of service, even if it cost you more taxes, which would you take? I asked that question in that form and I can tell you without fail, on every occasion when that question is asked, and I have asked that in audiences of 500 to 600, hundreds of people, invariably overwhelmingly, like 97 percent, will always say that reluctantly because nobody likes to pay taxes, they prefer taxes to reduction in services.

I believe that is plain common sense. They also know that if the taxes are not raised on a Federal level, then they will invariably be imposed at a local level, but only in those areas where localities can impose taxes generally.

New York City, I want to tell you, is better situated than almost any other city in America as it relates to the imposition of taxes. Our taxes are not overwhelmingly based on homeownership. Our taxes are not primarily derived from taxes on one or two family homeowners or business taxes. We are almost like a State in terms of what it is that we impose but overwhelmingly across America, that is not what the counties and the cities will be able to do. They will have to tax the one and two family homeowner who has no income at all related to his property and people understand that.

What is it that you might consider? It is interesting to me. In 1973, when I was here in 1974, we were talking about energy bills at that time, what OPEC was doing to us. My recollection is, and I hope it is correct, that there was a measure on the floor to increase gasoline taxes by 20 cents. I voted for it, the gasoline tax. It was terrible. It went down the tubes. We should have voted for it because think of all the money that would have come in. The Arabs voted for that 20 cent tax. [Laughter.]

They got it. We didn't. I look back at that. At the high in March 1981, gasoline was selling at something like $1.39. It is estimated that this fall gasoline will be $1.02. Why don't we impose a 20 cent tax on gasoline? Why don't we impose a tax on Btu's?

There is something else I want to give Governor Dukakis credit for, because he is the first one who proposed and enacted amnesty on taxes, and I can tell you what we did, we followed his suggestion. We took in just recently as a result over a 3-month amnesty, $370 million statewide. It is estimated that in the Federal area, $100 billion in taxes are not paid on the underground economy annually.

Why shouldn't we have a Federal comparable amnesty? You do it once in your lifetime. You don't do it regularly. I don't know that we will take in $100 billion. I bet we will. You won't only be attacking that 1 year, you are going to be attacking 6 years. Six years is what you have available out there to you, $600 billion. If they didn't file taxes, there is no statute of limitations. It is only

those miscreants who filed and defrauded that have a statute of limitations tax to them.

Think of that pot of gold out there that we ought to be looking to, to go into the public coffers. What I am suggesting, and I think what my colleagues are suggesting, is that you just don't give into the President. He is a very popular man. I happen to like him myself. That doesn't mean I have to agree with his policies. Fortunately for us Democrats, he can't run again. [Laughter.]

Therefore, we ought to take him on in a very nice respectful way. That means that you reenact general revenue sharing. I know undoubtedly my colleagues have suggested that was No. 1 for us. We spend that money on teachers. By the way, general revenue sharing is only about 3 percent of the total tax base that we have, whereas in many jurisdictions, the average across the country is 7 percent. In West Virginia, my recollection is that it is 23 percent; very high in some of the areas. We can take it on.

I believe you ought to reenact it, reauthorize it, and include it in whatever then reductions you are going to do and then finally, Gramm-Rudman, which in New York City is referred to as "Grimm-Rudman." [Laughter.]

It is unfair. It is unfair because it was sold by the President and Chief of Staff Donald Regan, as basically a 5-percent reduction. That is what they say. It is not true. The reductions are on a very limited part of the pie. You have a trillion dollar budget. Maybe the reduction would be less than 5 percent, if it were on the whole pie, but it is not. It is on a very small part, $300 billion. For us it would attack the services that we provide hugely. It would be a 15 percent reduction to New York City.

I am speaking of a special plea for New York City because we are going to come out better than any other city because our economy is so good. Nevertheless, we will suffer but we will not suffer as much as some other places where the economy is not so good. For New York City, if the President's budget were to go through, we would lose with the dollars that we have already lost this year, that have already been imposed, $1.8 million. That is what we would lose.

It is not fair. It makes no sense. You can stop it. Thank you.

[Testimony resumes on p. 912.]

[The prepared statement of Mr. Koch follows:]

PREPARED STATEMENT OF HON. EDWARD KOCH

THANK YOU FOR THE OPPORTUNITY TO TESTIFY ON BEHALF OF THE U.S. CONFERENCE OF MAYORS REGARDING THE PRESIDENT'S PROPOSED 1987 BUDGET.

IF HIS BUDGET WERE ENACTED, IT WOULD RESULT IN DEVASTATING REDUCTIONS IN ESSENTIAL LOCAL SERVICES AND INCREASES IN PROPERTY TAXES IN EVERY CITY, COUNTY, TOWN AND VILLAGE. IN NEW YORK CITY ALONE, IT WOULD RESULT IN A LOSS OF FEDERAL AID OF $1.551 BILLION IN 1987. COMBINED WITH ACTIONS THAT HAVE ALREADY BEEN TAKEN FOR FFY 1986, FEDERAL AID REDUCTIONS TO THE CITY AND ITS RESIDENTS WOULD CLIMB TO $1.851 BILLION.

I BELIEVE THAT THE FEDERAL BUDGET MUST BE BALANCED AND THAT IT CAN BE BALANCED IN A WAY THAT IS FAIR TO ALL REGIONS OF THE COUNTRY AND ALL SECTORS OF THE ECONOMY. A RATIONAL PROGRAM TO REDUCE EXPENSES COMBINED WITH NEW REVENUE MEASURES WOULD ENABLE US TO BOTH BALANCE THE BUDGET AND BE FAIR. I AM OPPOSED TO THE GRAMM-RUDMAN BALANCED BUDGET ACT BECAUSE IT BLINDLY RELIES UPON A FORMULA RATHER THAN REASON TO REDUCE THE DEFICIT. BUT GRAMM-RUDMAN WHICH WOULD REDUCE DEFENSE AND DOMESTIC PROGRAMS EQUALLY IS FAIRER THAN THE PRESIDENT'S PROPOSED BUDGET REDUCTIONS, WHICH SLASH THE FEDERAL AID PROGRAMS THAT FUND ESSENTIAL LOCAL SERVICES. HOWEVER, GRAMM-RUDMAN, REALLY SUBJECTS ONLY 36 PERCENT OF THE FEDERAL BUDGET TO ITS AUTOMATIC SPENDING REDUCTION PROGRAM. IN THIS WAY, ONLY $360 BILLION OF THE $1 TRILLION FEDERAL BUDGET WOULD EVER BE TOUCHED BY GRAMM-RUDMAN. IF ALL THE FEDERAL BUDGET WERE SUBJECT TO SPENDING REDUCTIONS, THE CUTS IN THE TARGETED DOMESTIC PROGRAMS, INSTEAD OF BEING 15 PERCENT, WOULD BE 3.9 PERCENT.

REDUCING THE DEFICIT THROUGH EXPENDITURE REDUCTIONS ALONE WHILE IGNORING REVENUE RAISERS IS BOTH UNREASONABLE AND UNFAIR.

I PROPOSE TO REDUCE THE DEFICIT BY INCREASING THE TAX ON A GALLON OF GASOLINE BY 20 CENTS. A 20 CENT INCREASE IN THE GASOLINE TAX WOULD RAISE $18 BILLION, AND, WITH OIL PRICES PLUMMETING, THE CONSUMER SHOULD NOT PAY A HIGHER AT-THE-PUMP PRICE. IN MARCH OF 1981, THE AVERAGE PRICE PER GALLON OF GASOLINE WAS $1.39, WHILE, NOW, THE PRICE PER GALLON IS PROJECTED TO FALL TO $1.02 BY THE FALL OF THIS YEAR. SINCE THE OIL EMBARGO IN 1973, THE OIL-PRODUCING COUNTRIES HAVE REAPED BILLIONS OF DOLLARS IN PROFIT FROM THE AMERICAN PUBLIC. NOW, IT IS TIME TO TAKE A PORTION OF THE SAVINGS THAT RESULT FROM LOWER PRICES AND EARMARK THEM FOR DEFICIT REDUCTION.

I WOULD ALSO PROPOSE THE ADOPTION OF A BROAD-BASED TAX ON ALL FORMS OF ENERGY CONSUMPTION, THE SO-CALLED ENERGY OR BTU TAX, IN PLACE OF OR IN COMBINATION WITH A GASOLINE TAX. A 5 PERCENT ENERGY TAX WOULD YIELD $15 BILLION IN ANNUAL REVENUES.

I ALSO ENDORSE SENATOR BILL BRADLEY'S PROPOSAL THAT WAS APPROVED BY THE SENATE DEMOCRATIC CAUCUS YESTERDAY THAT ANY NEW TAXES BE USED TO REDUCE THE DEFICIT RATHER THAN FINANCE THE RETENTION OF TAX LOOPHOLES. I WOULD GO FURTHER AND SAY THAT SOME OF THE PROVISIONS OF HR 3838, SUCH AS A STRONGER CORPORATE MINIMUM TAX AND REPEAL OF THE INVESTMENT TAX CREDIT, WHICH TOGETHER RAISE $23 BILLION A YEAR, BE USED TO FURTHER REDUCE THE DEFICIT.

IN THE 1950'S, CORPORATE TAXES COMPRISED 25 PERCENT OF ALL FEDERAL TAX RECEIPTS. IN 1987, IT IS PROJECTED THAT CORPORATE TAXES WILL COMPRISE 10 PERCENT OF FEDERAL TAX RECEIPTS. IT IS NOT UNREASONABLE TO ASK THAT THE BUSINESSES OF THIS COUNTRY, AGAIN, PAY THEIR FAIR SHARE FOR DEFICIT REDUCTION.

I ALSO STRONGLY ENDORSE GOVERNOR MICHAEL DUKAKIS' CALL TO REDUCE THE FEDERAL DEFICIT BY COLLECTING DELINQUENT FEDERAL TAXES. WE IN NEW YORK STATE AND NEW YORK CITY JUST COMPLETED AN EXTREMELY SUCCESSFUL AMNESTY PROGRAM THAT COLLECTED NEARLY $370 MILLION IN JUST THREE MONTHS. AND WE'RE STILL PROCESSING DELINQUENT PAYMENTS.

IRS DATA SHOWS THAT 19 PERCENT OF ALL FEDERAL TAXES ARE NOT PAID, RESULTING IN A TAX EVASION PROBLEM OF ABOUT $100 BILLION ANNUALLY. AMNESTY WON'T SUCCEED IN COLLECTING ALL OF THAT, BUT, IF THE NATIONAL TAX COMPLIANCE RATE REACHED WHAT IT WAS 20 YEARS AGO, THE FEDERAL GOVERNMENT SHOULD RECEIVE $65 BILLION IN NEW ANNUAL REVENUES WITHOUT RAISING TAXES. ONGOING ENFORCEMENT COULD YIELD AT LEAST $20 TO $25 BILLION IN FEDERAL REVENUES ANNUALLY

FAIR AND EQUITABLE REVENUE MEASURES SUCH AS THESE CAN CUT THE DEFICIT WITHOUT REDUCING LOCAL AID, REDUCTIONS WHICH JUST SHIFT THE BURDEN OF FUNDING THESE PROGRAMS FROM ONE LEVEL OF GOVERNMENT TO ANOTHER.

IF ALL OF THESE REVENUE MEASURES WERE ENACTED AND ONLY $20 BILLION WAS REALIZED FROM AMNESTY, THE $144 BILLION GRAMM-RUDMAN TARGET WOULD BE EXCEEDED BY $39 BILLION FROM THESE ACTIONS ALONE.

IF IT IS DECIDED THAT THE BEST COURSE OF ACTION IS TO INCLUDE SOME EXPENDITURE REDUCTIONS, THEN A RESPONSIBLE DEFICIT PROGRAM THAT REDUCES BOTH DEFENSE AND DOMESTIC PROGRAMS MUST BE CONSTRUCTED. THAT APPROACH IS MORE FAIR THAN THE PRESIDENT'S APPROACH WHICH REDUCES DOMESTIC PROGRAMS BY 3.4 PERCENT, IN REAL TERMS, WHILE INCREASING DEFENSE PROGRAMS BY 8.3 PERCENT. IF NECESSARY TO AVOID DRASTIC REDUCTIONS, GRAMM-RUDMAN COULD BE STRETCHED OUT SO THAT BUDGET BALANCE IS REACHED AFTER 7 YEARS RATHER THAN AFTER 5 YEARS. I SHOULD NOTE THAT THE FEDERAL BUDGET WAS ONLY BALANCED TWICE DURING THE LAST 25 YEARS.

FINALLY, I WANT TO ADD THAT THE GENERAL REVENUE SHARING PROGRAM (GRS) IS ONE OF THE LARGEST PROGRAMS SINGLED OUT BY THE ADMINISTRATION FOR COMPLETE ELIMINATION. IT IS THE ONLY FEDERAL PROGRAM BENEFITING ALL OF THE 39,000 LOCAL GOVERNMENTS ACROSS THIS NATION. THEREFORE, I AM EXTREMELY PLEASED THAT THE HOUSE SUBCOMMITTEE ON INTERGOVERNMENTAL RELATIONS AND HUMAN RESOURCES REPORTED OUT A THREE-YEAR REAUTHORIZATION OF THE GENERAL REVENUE SHARING PROGRAM TO THE COMMITTEE ON GOVERNMENT OPERATIONS THIS WEEK. FURTHERMORE, I WOULD LIKE TO NOTE THAT THE CONGRESSIONAL BUDGET OFFICE'S NEW LOWER BASELINE DEFICIT NUMBERS ASSUME THE REAUTHORIZATION OF GRS.

NOW LET ME COMMENT ON THE SPECIFIC PROPOSALS OF THE PRESIDENT'S 1987 BUDGET THAT IMPACT NEW YORK CITY AS WELL AS LOCAL GOVERNMENTS ACROSS THE COUNTRY.

GENERAL REVENUE SHARING

GENERAL REVENUE SHARING (GRS) IS ONE OF THE LARGEST PROGRAMS SINGLED OUT BY THE ADMINISTRATION FOR COMPLETE ELIMINATION. BENEFITING ALL OF THE 39,000 LOCAL GOVERNMENTS ACROSS THE NATION, THERE ARE AS MANY ARGUMENTS FOR CONTINUING THE $4.6 BILLION GRS PROGRAM AS THERE ARE UNITS OF LOCAL GOVERNMENT IN THIS NATION.

GRS IS TOO VITAL TO TOO MANY AMERICANS FOR THE CONGRESS TO PERMIT IT TO EXPIRE. THE PRESIDENT HAS NOT ONLY PROPOSED TO ELIMINATE THE PROGRAM IN 1987, BUT TO RESCIND THE LAST QUARTER OF FFY 1986 FUNDING. ADOPTION OF THE PRESIDENT'S PROPOSALS WOULD BE A DEVASTATING BLOW TO CITIES, TOWNS AND COUNTIES. GRS IS THE MOST FLEXIBLE FEDERAL PROGRAM THAT CAN BE USED BY EACH LOCAL GOVERNMENT TO MEET ITS OWN MOST PRESSING NEEDS. THE USES OF GRS VARY WIDELY:

- IN NEW YORK CITY, GENERAL REVENUE SHARING PAYS FOR TEACHERS.
- IN BOSTON, GRS PAYS FOR POLICE.
- IN DADE COUNTY, FLORIDA, GRS PAYS FOR SENIOR PROGRAMS.

- In Putter County, Texas, GRS funds meals on wheels and food banks, alcohol and drug recovery centers and a domestic violence center.
- In Pensacola, Florida, GRS provides critical funding to the community mental health center.

While GRS is the highest budget priority for New York City, this is not a big city program. Smaller, more rural communities rely far more heavily on GRS for supporting local services. For example, GRS represents over 20 percent of taxes raised by local governments in West Virginia and Arkansas and just 3.5 percent of taxes raised by local governments in New York State. Overall, GRS provides an amount equal to nearly 7 percent of taxes raised by local governments across the nation.

The result of eliminating GRS will be tax increases and cuts in essential services across the nation. It is ironic that an Administration that vows there should be no tax increase for Americans is virtually guaranteeing one at the local level by withdrawing support for GRS.

If GRS were eliminated as proposed by the President, property taxes in all local governments would have to be raised by 9.2 percent to make up the loss in federal aid. Or if local governments were to make up the loss from across the board service reductions, the loss of GRS nationally would be equivalent to the total of 18,494 police officers, 8,150 fire officers, 18,152 teachers, 20,220 human service workers and 26,065 street maintenance workers.

NEW YORK CITY HAS RECENTLY JOINED WITH OTHER CITIES, COUNTIES AND TOWNS THROUGHOUT THE COUNTRY TO FORM A NATIONAL COALITION TO SAVE GENERAL REVENUE SHARING CHAIRED BY DUTCH MORIAL, MAYOR OF NEW ORLEANS. WE INTEND TO MAKE OUR COLLECTIVE VOICES HEARD ON BEHALF OF THE REAUTHORIZATION OF THIS PROGRAM AND WE NEED YOUR SUPPORT.

THE NAME REVENUE SHARING IS MISLEADING. THE PROGRAM WAS NEVER INTENDED TO SHARE FEDERAL SURPLUSES, BUT WAS ENACTED TO OFFER THE BROAD TAX BASE OF THE FEDERAL GOVERNMENT TO SUPPORT VITAL LOCAL SERVICES. WHEN GRS WAS ENACTED IN 1972, THE FEDERAL GOVERNMENT SHARED 2.5 PERCENT OF ITS REVENUE WITH STATE AND LOCAL GOVERNMENTS. TODAY, 14 YEARS LATER, IT SHARES ONLY ONE HALF OF ONE PERCENT.

COMMUNITY DEVELOPMENT BLOCK GRANT

SINCE 1981, NEW YORK CITY HAS LOST OVER $142 MILLION IN FEDERAL COMMUNITY DEVELOPMENT REVENUES AS A RESULT OF REDUCED APPROPRIATIONS AND CHANGES IN THE DISTRIBUTION FORMULA.

THE PRESIDENT'S BUDGET PROPOSES TO DEFER $500 MILLION IN THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM (CDBG) IN 1986 AND USE THESE FUNDS IN 1987, REDUCING FUNDING FOR THE PROGRAM BY 17 PERCENT IN EACH YEAR. IN ADDITION TO CUTTING THE PROGRAM, THE ADMINISTRATION IS PROPOSING TO REDISTRIBUTE THE FUNDS BETWEEN URBAN AND RURAL AREAS FROM A SPLIT OF 70 PERCENT TO URBAN AREAS

AND 30 PERCENT TO RURAL AREAS TO 65 PERCENT URBAN AND 35 PERCENT RURAL.

THE CITY CURRENTLY USES COMMUNITY DEVELOPMENT FUNDS FOR BUILDING CODE ENFORCEMENT, LOANS FOR REHABILITATION OF LOW- AND MODERATE-INCOME RENTAL HOUSING, REVITALIZATION OF LOCAL BUSINESS DISTRICTS, AND INFRASTRUCTURE IMPROVEMENTS TO SUPPORT ECONOMIC DEVELOPMENT PROJECTS. AS AN IMPORTANT ELEMENT IN THE CITY'S HOUSING POLICY, THESE FUNDS HAVE PROVIDED FOR THE REHABILITATION OF MORE THAN 50,000 UNITS OVER THE PAST 5 YEARS. IF THE PROPOSED CUTS ARE ENACTED, OUR EFFORTS TO ENSURE DECENT HOUSING FOR THE CITY'S LOWER-INCOME FAMILIES WILL BE THWARTED.

THE U.S. CONFERENCE OF MAYORS, THE NATIONAL LEAGUE OF CITIES, AND CONGRESSMAN CHUCK SCHUMER HAVE SUED HUD TO PREVENT THE DEFERRAL OF CDBG FUNDS. THE SUIT IS BASED ON THE RECENT DECISION BY THE SUPREME COURT WHICH INVALIDATED THE ONE-HOUSE VETO THAT EFFECTIVELY NULLIFIED THE ENTIRE DEFERRAL PROCESS. NEW YORK CITY IS PLANNING TO JOIN IN THIS SUIT.

MASS TRANSIT

THE ADMINISTRATION IS, ONCE AGAIN, PROPOSING TO ELIMINATE OPERATING ASSISTANCE FOR MASS TRANSIT. THIS PROPOSAL WOULD COST THE METROPOLITAN TRANSPORTATION AUTHORITY APPROXIMATELY $110 MILLION, OF WHICH APPROXIMATELY $79 MILLION WOULD BE LOST TO THE NEW YORK CITY TRANSIT AUTHORITY.

THIS LOSS WOULD DIRECTLY AFFECT THE TRANSIT SERVICE FOR THE 1.6 BILLION PASSENGERS WHO RIDE THE NEW YORK CITY SUBWAYS, BUSES AND FERRIES ANNUALLY AND WOULD RESULT IN AN INCREASE IN SUBWAY AND BUS FARES.

THE ADMINISTRATION ALSO PROPOSES TO COMBINE CAPITAL HIGHWAY AND TRANSIT AID IN A NEW BLOCK GRANT, BUT REDUCES OVERALL MASS TRANSIT FUNDING BY $1.9 BILLION. WHILE THE PURPOSE OF THE BLOCK GRANT IS TO GIVE LOCALITIES MORE FLEXIBILITY IN MEETING THEIR TRANSPORTATION NEEDS, THE ADMINISTRATION SPECIFICALLY PROHIBITS URBAN AREAS WITH POPULATIONS EXCEEDING 200,000 FROM USING THESE FUNDS FOR OPERATING ASSISTANCE. THIS WILL RESULT IN A 45 PERCENT REDUCTION OF AID TO NEW YORK CITY, MAKING IT INCREASINGLY DIFFICULT FOR THE NEW YORK CITY TRANSIT AUTHORITY TO MEET ITS CAPITAL NEEDS WHICH ARE ESTIMATED AT $3.85 BILLION OVER THE NEXT 3 YEARS.

MEDICAID

THE PRESIDENT PROPOSES AGAIN THIS YEAR TO REDUCE FEDERAL SUPPORT FOR THE MEDICAID PROGRAM BY IMPOSING A CAP. THE ADMINISTRATION'S PROPOSED CAP, LIKE THEIR EARLIER ACTIONS TO REDUCE THE FEDERAL SHARE OF MEDICAID, IS ANOTHER ATTEMPT TO SHIFT THE COST OF MEDICAL CARE FOR THE NEEDY FROM THE FEDERAL GOVERNMENT TO STATE AND LOCAL GOVERNMENTS.

THE ADMINISTRATION'S PROPOSAL WOULD REDUCE THE 1987 FUNDING LEVEL BY $1.3 BILLION BY LIMITING FEDERAL REIMBURSEMENT TO STATES IN 1987 AT 9 PERCENT ABOVE THE 1985 LEVELS. AS A RESULT,

NEW YORK CITY WOULD LOSE $274 MILLION. A REDUCTION OF THIS MAGNITUDE IS COMPLETELY INCONSISTENT WITH THE DECISION BY CONGRESS TO EXEMPT THE MEDICAID PROGRAM, BECAUSE OF ITS CRITICAL NATURE, FROM THE GRAMM-RUDMAN AUTOMATIC SPENDING CUTS.

SINCE THE CITY WOULD STILL BE REQUIRED TO PROVIDE THE SAME SERVICES TO ALL PERSONS WHO ARE ELIGIBLE, THE LOSS OF $274 MILLION IN FEDERAL FUNDS UNDER THE PRESIDENT'S BUDGET WOULD HAVE TO BE MADE UP BY THE CITY AND THE STATE. THIS IS NOT A COST CONTAINMENT PROGRAM; IT IS A COST SHIFTING PROGRAM.

MOREOVER, CAPPING THE PROGRAM AT AN ARBITRARY LEVEL WOULD CHANGE THE FUNDAMENTAL NATURE OF THE MEDICAID PROGRAM FROM AN ENTITLEMENT PROGRAM TO A BLOCK GRANT, BY PRECLUDING GROWTH IN EXPENDITURES DUE TO INCREASES IN UTILIZATION AND CASELOAD SIZES.

Housing

SINCE 1981, THE FEDERAL HOUSING BUDGET FOR PUBLICLY-ASSISTED HOUSING HAS BEEN SLASHED FROM $30.9 BILLION IN 1981 TO $10.8 BILLION IN 1986. THE PRESIDENT'S BUDGET FURTHER REDUCES THE 1986 FUNDING LEVEL TO $3.7 BILLION, AND THEN CUTS THE 1987 LEVEL TO $2.3 BILLION.

ALL FEDERAL FUNDING FOR HOUSING CONSTRUCTION AND REHABILITATION TERMINATES UNDER THE PRESIDENT'S PROPOSAL. THE ONLY FEDERAL HOUSING PROGRAM THE PRESIDENT WOULD CONTINUE IS THE SECTION 8 VOUCHER PROGRAM.

THE CITY CURRENTLY HAS A HOUSING VACANCY RATE OF 2 PERCENT. WE HAVE A WAITING LIST OF 200,000 FAMILIES FOR PUBLIC HOUSING, WHICH IS MORE THAN THE ENTIRE CAPACITY OF NEW YORK CITY'S 153,000 FEDERALLY ASSISTED PUBLIC HOUSING UNITS AND FOR WHICH THERE ARE NO VACANCIES. THE 1985 TURNOVER RATE OF 3.2 PERCENT WAS THE LOWEST IN THE HISTORY OF THE NEW YORK CITY HOUSING AUTHORITY.

IT IS NO WONDER THAT NEW YORK CITY IS SHELTERING MORE HOMELESS PEOPLE THAN AT ANY TIME SINCE THE GREAT DEPRESSION. YET, THIS YEAR, THE PRESIDENT IS COMPLETELY WIPING OUT THE REMAINS OF THE SUBSIDIZED HOUSING PROGRAMS, WHICH WILL ONLY FURTHER AGGRAVATE THE SITUATION.

OTHER REDUCTIONS TO THE CITY OF NEW YORK INCLUDE:

- AN INCREASE IN MEDICARE RESULTING IN A FEDERAL AID LOSS OF $33.7 MILLION;

- RESTRICTIONS ON AFDC THAT WILL RESULT IN A LOSS OF $20 MILLION;

- A RESCISSION AND ELIMINATION OF THE COMMUNITY SERVICES BLOCK GRANT AND WIN FOR A FEDERAL AID LOSS OF $41 MILLION;

- A STRETCH OUT OF THE WESTWAY TRADE-IN GRANTS THAT WOULD COST THE CITY $88.4 MILLION IN FEDERAL AID;

- A RESCISSION AND ELIMINATION OF URBAN DEVELOPMENT ACTION GRANTS AND ECONOMIC DEVELOPMENT, COSTING $24.6 MILLION IN FEDERAL AID;

- ADDITIONAL REDUCTIONS IN VARIOUS PROGRAMS OF $63.1 MILLION.

ATTACHED TO MY REMARKS IS A COPY OF OUR PRELIMINARY ANALYSIS OF THE EFFECTS OF THE PRESIDENT'S PROPOSED 1987 BUDGET ON NEW YORK CITY AND ITS RESIDENTS. I HOPE THAT YOU WILL INCLUDE IT IN THE RECORD.

IN THE LAST THREE YEARS,THE UNITED STATES CONGRESS AND THE NEW YORK CITY AND STATE DELEGATIONS HAVE MANAGED TO RESIST MANY OF THE ATTACKS THE ADMINISTRATION HAS MOUNTED ON PROGRAMS WHICH SERVE OUR RESIDENTS. THE PRESIDENT'S NEW BUDGET PROPOSALS ARE BY FAR THE WORST SUCH ASSAULT. WE MUST WORK TOGETHER NOW TO DEFEND THE INTERESTS OF THIS CITY AS WELL AS ALL LOCAL GOVERNMENTS ACROSS THIS COUNTRY.

The CHAIRMAN. Thank you very much, Mayor Koch. Let me welcome you to the Budget Committee and back to Washington, DC. We are certainly glad your plane was able to get here and that you were able to share your views with this State and local panel. We certainly appreciate those views.

Let me just say you called it "Grimm-Rudman"——

Mr. KOCH. Yes, sir.

The CHAIRMAN [continuing]. One of my colleagues, Congressman Parren Mitchell, from Baltimore, who will be retiring from the Congress, is an eloquent spokesperson for the least of these in our society and particularly for urban America, I believe he calls it the "Urban Terrorism Act of 1985." [Laughter.]

I thought I would share another perspective from another one of your former colleagues who has served with you in the House of Representatives.

I want to thank this panel for your views, for your time. We certainly deeply appreciate it.

At this time the Chair calls to the witness table Gerald W. McEntee, Mary Futrell, and Vince Sombrotto. We ask those witnesses to move to the witness table and we will begin our second panel on labor and Federal relations.

I am pleased to welcome the panel before the committee today, including representatives of three distinguished labor organizations. Gerald McEntee, the president of the American Federation of State, County, and Municipal Employees, who I might also add is a hometown Philadelphia product; Mary Futrell, president of the National Education Association; and Vince Sombrotto, representing the Fund for Assuring an Independent Retirement, often known as FAIR.

I also want to take this opportunity to thank you for your past efforts in keeping this committee informed regarding the issues of importance to your constituents. I know that you strongly share my conviction that an appropriate Federal budget policy must provide for our essential national priorities. At the same time it must pursue a fair and balanced approach to deficit reduction.

The committee needs to learn the potential impact of the President's budget proposals on the delivery of basic services to this nation. The three of you represent those who are out there on the front line delivering basic services to the people of this Nation. We want to know if the President's budget is adopted, what would it mean in the areas where you have your expertise. We are here to listen and to learn from you and to discuss any possible alternatives you may suggest.

We ask you to summarize your testimony, and it will be submitted in its entirety for the record. We will begin first with Mr. McEntee, then Ms. Futrell, and Mr. Sombrotto. If you could summarize and hit the highlights, we would appreciate it.

STATEMENT OF GERALD W. McENTEE, PRESIDENT, AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES

Mr. MCENTEE. Thank you, Mr. Chairman.

I appreciate this opportunity to comment on the administration's proposed budget because I believe a fraud is being perpetrated on

the American people. The administration claims its budget has two overriding virtues. One, that it only cuts unnecessary programs, the fat. Two, it will not hurt family budgets because it will not raise taxes. Both of these claims are patently false.

Medicare, Medicaid, student loans, and aid to mass transit are all essential programs and they are all jeopardized by this budget.

Taxes will also be raised by this budget because the massive cuts in aid to State and local government will force a huge wave of sales, property and State and local income tax increases across the land. The budget ignores the revenues that are available from closing corporate loopholes and instead forces tax increases that will fall on middle class Americans.

To fully assess the damage that would be done by the administration, we contracted with Fiscal Planning, Inc. for a detailed State by State study.

Mr. Chairman, I would like to submit to the committee our State by State study on that.

The CHAIRMAN. Without objection.

[The study referred to above may be found in committee files.]

Mr. MCENTEE. According to our State by State report, the proposed budget shifts or if you will, dumps responsibility onto State and local governments by cutting $16.2 billion or 16 percent from grants and aid. These costs will be imposed on State and local governments.

For example, the budget caps the Medicaid Program. Funding is deliberately set below the level of need. AFSCME members who work in public hospitals throughout the country know this means sick people; sick people turned away from private hospitals with no means to pay for their care, will show up at the public hospital door. The problem is already serious.

Chicago's Cook County Hospital had a 500-percent increase in patient transfers between 1980 and 1984. In Dallas, patient transfers to Parkland Memorial Hospital increased 300 percent from 1983 to 1985.

These people are cared for but the cost is transferred from Washington to local governments. Cuts in housing, food stamps, and nutrition programs all have the same effect. Nearly half of the cities across the country experienced an increase in demands for emergency food and shelter in 1985. New cutbacks will add to these problems which must be met with local funds.

As if these increased costs weren't enough, the administration also proposes to eliminate the mainstay Federal program for local governments, General Revenue Sharing. This budget also imposes massive new costs on the States. State finances have been buffeted by problems from trade to oil. Already 14 States have had to reopen their budgets to make cuts because of revenue shortfalls, before the March 1 Gramm-Rudman cuts. There will undoubtedly be more to come.

As detailed in our state of the States' report, absorbing the administration's grant and aid cuts would throw 44 out of the 50 States into deficit. As you can see from the charts that our organization has brought together and brought with us, that to most States dealing with these cuts will be overwhelming.

A farm State like Iowa with a meager $2.4 million surplus now, gained after its own stringent across-the-board spending cuts, is being asked to absorb another $176 million Federal budget cuts.

Oil States like Texas and Louisiana are already expecting year-end deficits. Deficits that would be increased by these cuts to $1.2 billion and $404 million respectively.

Even States considered to be in good fiscal health could see the red ink. In Massachusetts, a $217 million balance could turn into a $244 million deficit. In California, an $817 million surplus, could result into a $933 million deficit.

States will not be able to help themselves let alone their local governments. The national income and products accounts show an operating surplus for all States and local governments of $3.3 billion. The March Gramm-Rudman cuts and the 1987 proposed budget cuts would turn that $3.3 billion surplus into a $15 billion deficit. It is little wonder that in the recent National League of Cities survey, 38 percent of cities said they could not maintain existing service levels without a tax rate increase.

In the Northeast, it is a 55-percent increase. Property taxes will go up. States will have to raise their sales and income taxes, State and local taxes are still more regressive than Federal taxes.

The administration's tax tradeoff is a poor one indeed for the family budget. As for the poor tradeoffs, the administration is a prime example of penny wise and pound foolish. What sense is there in eliminating the WIN Program which has been used so successfully in Massachusetts and elsewhere to provide real training and real decent paying jobs for welfare recipients? Why cut education programs that bring into the mainstream the physically, economically, and culturally handicapped and teach them specific job skills? What sense is there in cutting loans that allow middle class students to attend college when our Nation so critically needs a skilled workforce for economic competitiveness and economic growth?

Cutting infrastructure funding from highways and bridges to water quality, threaten the safety and health of all Americans.

The growing cost of these unmet needs already estimated at more than one-half trillion dollars will inevitably be shifted onto the next generation. These are all programs that are essential to the middle class, the poor, and the future of our country.

Where does that leave us? Of course, we need to cut the deficit but not, I hasten to add, to zero. The American people know there is a better way to cut the deficit. We have only to look at the cause of the deficit to find the way. Tax loopholes contributed $326 billion to the deficit between 1982 and 1985. Increases in defense spending contributed an additional $77 billion. Over that same period, domestic spending declined by $176 billion. Declining domestic spending has already contributed far more than its fair share of deficit reduction.

The best solution to the deficit problem is clear to all of us. We must freeze defense spending, hold the growth to zero rather than 12 percent, and we must as poll after poll shows the public demands, raise revenues by closing corporate tax loopholes.

Middle class Americans have sacrificed enough for the Federal deficit. The poor have contributed more than their fair share. It is

time now for sensible Pentagon spending and it is high time corporate America paid its fair share.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McEntee follows:]

PREPARED STATEMENT OF GERALD W. MCENTEE

Mr. Chairman, I am Gerald W. McEntee, president of the American Federation of State, County and Municipal Employees. AFSCME represents 1.4 million public employees throughout the country in 48 states.

I appreciate this opportunity to comment on the administration's proposed budget, because I believe that a fraud is being perpetrated on the American people. The administration claims its budget has two overriding virtues: one, that it only cuts unnecessary programs—the "fat"; and two, that it will not hurt family budgets because it will not raise taxes.

Both of these claims are patently false. Medicare, Medicaid, student loans and aid to mass transit are all essential programs and they all are jeopardized by this budget. Taxes will also be raised by this budget because the massive cuts in aid to state and local government will force a huge wave of sales, property and state and local income tax increases across the land. The budget ignores the revenues that are available from closing corporate loopholes, and instead forces tax increases that will fall on middle class America.

To fully assess the damage that would be done by the Administration, we contracted with Fiscal Planning, Inc. for a detailed state by state study.

According to our State of the States report, the proposed budget shifts, or if you will, dumps responsibility onto state and local governments by cutting $16.2 billion or 16 percent from grants-in-aid. These costs will be imposed on state and local governments.

For example, the budget caps the Medicaid Program. Funding is deliberately set below the level of need. AFSCME members who work in public hospitals throughout the country know that this means that sick people, turned away from private hospitals, with no means to pay for their care, will show up at the public hospital door. The problem is already serious. Chicago's Cook County Hospital had a 500 percent increase in patient transfers between 1980 and 1984. In Dallas, patient transfers to Parkland Memorial Hospital increased 300 percent from 1983 to 1985. These people are cared for, but the cost is transferred from Washington to local governments.

Cuts in housing, Food Stamps, and nutrition programs all have the same effect. Nearly half of the cities across the country experienced an increase in demands for emergency food and shelter in 1985. New cutbacks will add to these problems, which must be met with local funds.

As if these increased costs weren't enough, the administration also proposes to eliminate the mainstay Federal program for local governments, General Revenue Sharing.

This budget also imposes massive new costs on the States. State finances have been buffeted by problems from trade to oil. Already, 14 States have had to reopen their budgets to make cuts because of revenue shortfalls—before the March 1 Gramm-Rudman cuts. There will undoubtedly be more to come.

As detailed in our state of the States report, absorbing the administration's grant-in-aid cuts would throw 44 out of 50 States into deficit. As you can see from the charts, for most States, dealing with these cuts it will be overwhelming. A farm state like Iowa, with a meager $2.4 million surplus, gained after its own stringent across-the-board spending cuts, is being asked to absorb another $176 million Federal budget cuts. Oil states like Texas and Louisiana are already expecting year-end deficits—deficits that would be increased by these cuts to $1.2 billion and $404 million, respectively. Even States considered to be in good fiscal health could see the red ink. In Massachusetts a $217 million balance could turn into a $244 million deficit; in California an $817 million surplus could dissolve into $933 million deficit.

States will not be able to help themselves, let alone their local governments. The National Income and Products Accounts show an "operating surplus" for all State and local governments of $3.3 billion. The March Gramm-Rudman cuts and the 1987 proposed budget cuts would turn that $3.3 billion surplus into a $15 billion deficit.

It is little wonder that in the recent National League of Cities survey 38 percent of cities said that they cannot maintain existing service levels without a tax rate increase. In the Northeast it's 55 percent. Property taxes will go up. States will have to raise their sales and income taxes.

State and local taxes are still more regressive than Federal taxes. So the administration's tax tradeoff is a poor one indeed for the family budget.

And as for poor tradeoffs, the administration is a prime example of penny wise and pound foolish. What sense is there in eliminating the WIN program that has been used so successfully in Massachusetts and elsewhere to provide real training and real, decent paying jobs for welfare recipients?

Why cut education programs that bring into the mainstream the physically, economically, and culturally handicapped, and teach them specific job skills?

What sense is there in cutting loans that allow middle class students to attend college when our Nation so critically needs a skilled workforce—for economic competitiveness and economic growth?

And cutting infrastructure funding—from highways and bridges to water quality—threaten the safety and health of all Americans. The growing cost of these unmet needs, already estimated at more than one-half trillion dollars, will inevitably be shifted onto the next generation.

These are all programs that are essential, to the middle class, to the poor, and to the future of our country.

So where does that leave us? Of course we need to cut the deficit but not, I hasten to add, to zero. The American people know there is a better way to cut the deficit. We have only to look at the cause of the deficit to find that way.

Tax loopholes contributed $326 billion to the deficit between 1982 and 1985. And increases in defense spending contributed an additional $77 billion. Over that same period domestic spending declined by $176 billion. Declining domestic spending has already contributed far more than its fair share of deficit reduction.

The best solution to the deficit problem is clear to all of us. We must freeze defense spending—hold the growth to zero rather than 12 percent. And we must—as poll after poll shows the public demands—raise revenues by closing corporate tax loopholes. Middle class Americans have sacrificed enough for the Federal deficit. The poor have contributed more than their fair share. It's time now for sensible Pentagon spending, and it's high time corporate America paid its share.

The CHAIRMAN. Thank you very much, Mr. McEntee. Now, to Mary Futrell, the president of the National Education Association. We welcome you to the House Budget Committee. We are grateful for the leadership you have been providing as head of NEA. Won't you proceed?

STATEMENT OF MARY HATWOOD FUTRELL, PRESIDENT, NATIONAL EDUCATION ASSOCIATION

Ms. FUTRELL. Thank you very much, Mr. Chairman.

Mr. Chairman and members of the committee, I am Mary Hatwood Futrell, president of the 1.8 million member National Education Association. We deeply appreciate this opportunity to testify on the President's budget for fiscal year 1987.

We recognize that the Congress has some very hard choices before it. Our present economic situation, marked by enormous Federal deficits and yet increasing social needs, has limited the available options.

We trust that this committee will continue to do what it has done in the past, recognize that education is an essential investment in our national life, an inextricable thread in the fabric of our society, and a critical element in the expansion of our economy, the security of our Nation, and the well-being of our people.

Mr. Chairman, education is more than just the key to jobs, to advancement, to human dignity. Education is the key to the very future itself. Yet this administration would shut the door on progress. It would close its eyes to the historic Federal role in enhancing American education and would drastically reduce our financial commitment to it.

We believe that the numbers speak for themselves. Under the President's budget, funding for the U.S. Department of Education would be reduced to $15.2 billion for fiscal year 1987, $3.9 billion less than the fiscal year 1985 appropriation level and $3.2 billion less than the amount appropriated by the Congress for fiscal year 1986.

This would represent a 20-percent reduction in just 2 years, without even taking into account the effects of past budget cuts or inflation. Indeed, the administration's recommendations fall more than $7.3 billion short of what would be needed just to maintain fiscal year 1980 funding levels after accounting for inflation.

Moreover, the administration would augment these reductions with even greater cuts in the future. The President's budget projects decreasing U.S. Department of Education funding to $14 billion by 1991.

Compared to the current fiscal year, this budget proposal would exclude by the administration's own account, some 250,000 eligible children from the chapter 1 program; 1,360,000 college age students from financial assistance program; 12 million youngsters from partial subsidies for school lunch; 420,000 children from partial subsidies for school breakfast. These losses would accelerate an unfortunate trend that has accompanied this administration's term in office. Since 1980, for instance, more than 1 million students have lost access to chapter 1 programs.

The administration claims to want to make choice the linchpin of its educational policy but this budget proposal reduces to zero the choices available to hundreds of thousands of children and young adults.

The White House continues to call for an ever smaller Federal role in public education, citing four C's as priorities; content, character, choice and citizenship, and omitting a fifth C, commitment.

The administration appears to have declared a victory in the education reform movement and is now poised to ride into the sunset. Indeed, its proposed budget sounds a retreat from excellence, a retreat from equity, a retreat from investing in human resources, and a retreat from investing in the future. Left behind will be our economic and technical progress, our position in the international community, and the hopes and dreams and opportunities of millions of young Americans. As a Nation, we simply cannot afford such losses.

Nor can our States and localities bear the increased burden this will create. In recent years, State and local governments have placed greater emphasis on the importance of public education, and have supported that commitment with resources. This renewed commitment has resulted in a number of notable successes, as State after State has raised taxes to fund education reform initiatives. The ability of State and local governments to provide these resources would not have been possible without Federal assistance.

Mr. Chairman, it is your committee's responsibility to take the first step in determining our Government's priorities for the coming years.

Since 1981, these priorities have been sadly out of kilter. Defense spending has more than doubled while investment programs such as education, have made major sacrifices. We have heard countless

lectures on the need for austerity to reduce the deficit, yet we watch vital funding for education programs shifted to programs that threaten rather than ensure our security.

Without a strong system of public education, there can be no national security. There can be no progress in any area.

We can find solutions to the problems that face us. We can create new opportunities for growth and prosperity. We can bring up the quality of life for all Americans. Like any enterprise, it will take a sound investment. Public education is such an investment.

The NEA asks that you lead this country into a future filled with promise while providing adequate support. We urge you to reject the President's budget, to safeguard education from further cuts and to assure that need based programs, such as chapter 1, are able to maintain a level equivalent to current services. With adequate Federal support, we can provide a system of public education that is more than adequate and we can provide excellence.

Thank you very much.

[Testimony resumes on p. 937.]

[The prepared statement of Ms. Futrell follows:]

PREPARED STATEMENT OF MARY HATWOOD FUTRELL

Mr. Chairman and Members of the Committee:

I am Mary Hatwood Futrell, president of the 1.8 million member National Education Association. We deeply appreciate this opportunity to testify on the President's budget for fiscal year 1987 -- a matter that will have far reaching implications not only for the level of federal expenditures in the coming year but for the very direction and substance of national education policy throughout the decade of the 1980's and beyond.

We recognize that the Congress has some very hard choices before it. Our present economic situation -- marked by enormous federal deficits and yet increasing social needs -- has limited the available options. But we trust that this Committee will continue to do what it has done in the past -- recognize that education is an essential investment in our national life; an inextricable thread in the fabric of our society; and a critical element in the expansion of our economy, the security of our country, and the well-being of our people.

Mr. Chairman, education is more than just the key to jobs, to advancement, to human dignity. Education is the key to the very future itself. Yet this Administration would shut the door on progress. It would close its eyes to the historic federal role in enhancing American education and would drastically reduce our financial commitment to it.

The numbers speak for themselves. Under the President's budget, funding for the U.S. Department of Education would be reduced to $15.2 billion in FY87 -- $3.9 billion less than the FY85 appropriation level and $3.2 billion less than the amount appropriated by the Congress for fiscal year 1986. This would represent a 20 percent reduction in just two years -- without even taking into account the effects of past budget cuts or inflation. Indeed, the Administration's recommendations fall more than $7.3 billion short of what would be needed just to maintain fiscal year 1980 funding levels after accounting for inflation.

Moreover, the Administration would augment these reductions with even greater cuts in the future. The President's budget projects decreasing U.S. Department of Education funding to $14 billion by 1991.

In terms of specific programs, the proposed plan would slash $2 billion from financial assistance to college students, $441 million from vocational education, $200 million from institutional aid to higher education institutions, $772 million from child nutrition programs, $700 million from job training, $200 million from handicapped education and handicapped vocational rehabilitation, $84 million from the Corporation for Public Broadcasting. It proposes complete elimination of Impact Aid `B` payments, assistance to public libraries, aid for asbestos abatement, the Juvenile Justice Program, Carl D. Perkins scholarships, immigrant education, Excellence in Education

Demonstration grants, Follow Through, civil rights technical assistance, the Women's Education Equity Act, Ellender Fellowships, consumer and homemaking education, handicapped independent living, international education, cooperative education, graduate and professional opportunity grants, and academic facilities grants. It advocates the consolidation of Indian education programs, teacher training and improvement programs, grants and work study programs for postsecondary students, aid for disadvantaged postsecondary students, and several smaller programs -- consolidations that represent more than $700 million in additional cuts to education.

Compared to the current fiscal year, this budget proposal would exclude -- by the Administration's own count -- some 250,000 eligible children from the Chapter 1 program; 1,360,000 college-aged students from financial assistance program; 12 million youngsters from partial subsidies for school lunch; 420,000 children from partial subsidies for school breakfast. These losses would accelerate an unfortunate trend that has accompanied this Administration's term in office. Since 1980, for instance, more than 1 million students have lost access to Chapter 1 programs.

The Administration claims to want to make 'choice' the linchpin of its educational policy. But this budget proposal reduces to zero the choices available to hundreds of thousands of children and young adults.

The White House continues to call for an ever smaller federal role in public education, citing `4 Cs' as priorities -- content, character, choice, and citizenship, and omitting a fifth C, commitment. The Administration appears to have declared a victory in the education reform movement and is now poised to ride into the sunset. Indeed, its proposed budget sounds a retreat from excellence, a retreat from equity, a retreat from investing in human resources, a retreat from investing in the future. Left behind will be our economic and technical progress, our position in the international community, and the hopes, dreams, and opportunities of millions of young Americans.

As a nation we simply cannot afford such losses.

Nor can our states and localities bear the increased burden this will create. In recent years, state and local governments have placed greater emphasis on the importance of public education, and supported that commitment with resources. This renewed commitment has resulted in a number of notable successes, as state after state has raised taxes to fund education reform initiatives.

But the ability of state and local governments to provide these resources would not have been possible without federal assistance. Particularly in states which have traditionally underfunded public education, the help of the federal government in compensatory education, education for the handicapped, and

vocational education has been crucial to giving state and local governments the necessary means to enhance the quality of instruction and the academic achievement of their students.

Federal role vital at this crucial time

The Administration's proposal discounts federal education expenditures as non-essential to the fate of the programs it helps support. This simply is not the case. Regrettably, the federal share of education spending is now only 6.2 percent of all educational expenditures -- its lowest level in over two decades. We must reverse this decline. Without the full partnership of the federal government states and local governments will not have the resources to meet our national needs.

Many states that have increased their commitment to education face serious obstacles in raising new revenues to support programs that this budget proposal would abandon. The pressures on states due to a decline in manufacturing, agriculture, and energy development have caused a loss of revenue in all areas of state government, a loss that threatens recent gains in public education.

These states are beset by fiscal problems on all sides. Overall, the Administration proposes to reduce aid to state and local governments in all areas by 19 percent. In fact, under this

budget, federal assistance to states and localities will drop by 1991 to less than half (in constant 1982 dollars) of what it was at the time this Administration came into office. By 1991, federal aid to state and local governments will amount to only 3.9 percent of all federal outlays and 0.7 percent of the gross national product.

At the same time, the states are unable to continue to come back each year and raise revenue through the same sources. In fact, 14 states have been forced to cut their fiscal 1986 budgets since they were passed last year, and these cuts -- especially those in education -- come from muscle and bone.

The effect on students

Mr. Chairman, most discussions of federal budget policy focus -- for obvious reasons -- on the money involved. Today, I would like to spend some time discussing the effects of the President's budget on what those dollars represent: programs for people.

Chapter 1

The budget proposes $3.6 million for Compensatory Education for Disadvantaged Children. In 1980, only 45 percent of students eligible for compensatory programs had such programs available in their schools. In 1985, only 31 percent had such programs available. Since 1980, 1 million children have been dropped from

the program. The Chapter 1 program requires an increase of $148 million just to reach the 250,000 children who would lose Chapter 1 funding this year. To develop programs for those children dropped from the program since 1980 would require an increase of $738 million. The cost of continued reductions in this program cannot be counted in dollars. For most of these children, lost opportunities can never be regained.

The Administration's proposal for a further raid on funds available for compensatory education through the voucher proposal is unconscionable. Each individual student in a compensatory program does not receive precisely $600 worth of services in the program, but the value of that funding pooled for the benefit of all participants. This proposed drain of Chapter 1 funds would rob current beneficiaries, and does not offer any promise of improvements in either public or private schools.

Vocational Education

This budget proposal calls for a reduction of more than half of the funding for vocational education. We believe this proposal is counterproductive -- from the standpoint of the nation's economic development -- and elitist, in that the rationale given is that all students should pursue college preparatory course work. We agree that all students must be well-grounded in the basic skills of English, math, science, and social sciences. But students should also have the opportunity to choose vocational

training over college-preparatory electives if that is more in line with their career goals.

In America's rapidly changing workplace lifelong education is a necessity, and vocational education programs address that need for training and retraining. It is a critical element in the economic security of our nation.

Higher Education

The proposed budget for student grants and work study -- which amounts to two-thirds of the proposed cuts in the Department of Education budget -- would eliminate opportunities for more than 1,360,000 students. By changing the eligibility requirements for Direct Student Loans and Guaranteed Student Loans, the Administration proposes eliminating funding options for another 687,000 students. The economic and social costs to this nation of such a loss would be tremendous.

The proposed changes in eligiblity for both the grant and loan programs are unrealistic. In the proposed eligibility changes for Pell Grants, the Administration would have us believe that only families with an income under $23,000 could possibly need assistance in paying for a student's college education.

Colleges and universities throughout the nation are raising tuition, fees, and other expenses. Most states are continuing to

provide additional assistance to support higher education. Families and individuals continue to make every sacrifice to make a college education possible. But despite these efforts, growing costs are forcing hundreds of thousands of qualified young people to defer or forgo postsecondary education. The loss of intellectually qualified students these proposal would create would stifle our intellectual, technological, and economic growth.

Impact Aid

The Administration continues to call for a retreat from its responsiblity to compensate for the loss of funding in a school district because of federal activities. In doing so, all students in a school district must bear the burden for the presence of federal installations. The proposed reduction of $144.5 million -- including the elimination of $130 million in Impact Aid `B` payments -- will seriously detract from the ability of local school districts' efforts to improve academic quality, and will in fact force many affected districts to move backward. Additionally, the freeze of Impact Aid `A` payments has not kept pace with inflation over the past two years that it has been frozen. The federal government, as an employer and property owner, should maintain its commitment to the school community as any other neighbor.

Handicapped Education and Handicapped Vocational Rehabilitation

This proposal recommends a cut of $107 million in Handicapped Education and a cut of $90 million in Handicapped Vocational Rehabilitation. Yet the proposal acknowledges that despite this massive cut, these programs must continue. This recommendation runs counter to the Administration's stated goal that ``all students should have an equal educational opportunity regardless of race, national origin, color, sex, or handicapping condition.``

The Department of Education's figures reflect that 30,000 more handicapped students will need special assistance in the 1986-87 school year than in the 1985-86 school year, but states and local governments are expected to provide the same level of service to more students with a 6.5 percent reduction in funds. In the same way, the 930,000 persons participating in vocational rehabilitation programs must get along with a 7.5 percent reduction.

These are not small reductions. The proposed cuts for vocational rehabiliation, for example, represent approximately $100 less to be allocated per student in FY 1987 than in FY 1986.

In 1980, there were four million students enrolled in handicapped education programs, and the federal government provided 12 percent of the costs above the average per pupil expenditures in

a given school district. In the 1987-88 school year, there are projected to be more than 4,180,000 handicapped students enrolled in public schools, and the federal government will provide only seven percent of the excess costs.

Parents of handicapped children are an excellent example of families that do not have the choices of which the Administration speaks. Most private schools do not accept physically handicapped children, and even if they did, no schools come close to the quality of services provided handicapped students in the public schools.

Education of the handicapped is a moral and economic necessity for this country, as is education for all children. This proposal would provide a measure of equity in that all would suffer.

Bilingual Education

The Administration proposes a $4.3 million increase in Bilingual Education. The increase would allow some 9,000 more students to acquire language skills and academic skills. But in order to accomplish this, the Administration is proposing taking $3.6 million from bilingual programs for youth in vocational programs. If this cut is enacted, approximately 7,500 young people could lose a chance to enter the workforce.

Under current spending levels, 130,000 fewer students will have access to bilingual programs than in 1980. In addition, state and local governments have had to assume more of the costs of the ones who are served. In 1980, the federal government provided approximately $485 per student. Under this proposal, in 1987 the federal government will provide only $271 per student.

Immigrant Education

The Administration proposes eliminating $30 million in assistance to school districts enrolling substantial numbers of immigrant children. These districts do have special needs that cannot generally be met from existing funds. A school district cannot predict a large influx of immigrants into the area the way normal demographic projections can be used to plan hiring, construction, and other needs. Often there is a lag between the time immigrant families move into an area and the time those families begin to hold fulltime employment, pay property taxes, and otherwise contribute to the tax base which supports a school district. Because of the continued instability in the world, and the continued attraction of the United States, this program should be continued and fully funded.

Indian Education

The Administration's proposed freeze for education programs to serve American Indians/Alaskan Natives -- accomplished by merging

education programs in the Department of the Interior and Department of Education -- will result in a net loss in the average per-pupil allocation to the students who are beneficiaries of the program. Since 1980, qualified participants have lost approximately $100 per student in federal funds.

Teacher Training and Improvement

The Administration boasts of a 38 percent increase in funding for teacher training and improvement, citing that as a `forceful indication of the Administration's commitment to excellence in teaching.` In fact, this proposal represents an $18.5 million reduction in available funding for teacher training and improvement.

Major reductions in funding for Special Education Personnel Development and Vocational Rehabilitation Training and the elimination of Carl Perkins Scholarships and Ellender Fellowships are significant steps backward in the effort to provide qualified teachers for the future and provide current teachers will new skills.

Magnet Schools

The Magnet Schools program has proven effective in its aims, increased parental involvement and support of the schools,

improved student motivation andacademic achievement, and has been an effective means of achieving voluntary desegregation. Yet the Administration proposes a freeze which would not encourage expanding the program beyond the 44 school districts.

A significant number of the 16,000 school districts in this country could benefit from such a program, and expanding the federal investment in magnet schools would allow for greater visibility in other areas areas of the country.

Chapter 2

Chapter 2 block grants consolidated some 25 categorical programs with a combined appropriation of approximately $760 million. The current level of funding -- which the Administration proposes freezing at $512 million -- does not even come close to meeting the level of services provided under Chapter 2 antecedent programs.

Additionally, the Administration's proposal justifies many of its other cuts by suggesting that those programs can be funded with Chapter 2 grants. School districts are finding it increasingly difficult to spend the same amount of money -- lessened in buying power through inflation -- to cover a greater number of programs.

International Education and Foreign Language Studies

The knowledge gap between Americans and citizens of other countries is well-documented. In order for our nation to survive in today's world, we must continue to encourage our young people to gain a practical understanding of other peoples, including their languages, and their social, political, and economic structures and customs. The Administration's proposed elimination of $32 million in funding for such programs ignores the need for greater awareness of other world cultures and the importance of such knowledge to American security and prosperity.

Child Nutrition

The Child Nutrition Programs would be cut by more than $772 million. Of that, more than $350 million will be taken from School Nutrition programs. More than 12 million children would be cut from school lunch subsidies, and more than 420,000 children would be cut from school breakfast subsidies. The other Child Nutrition programs have a direct bearing on school performance, as well. In a nation of prosperity such as ours, it is criminal to make these type of cuts.

Headstart

The proposed freeze in Head Start programs would represent a reduction in the number of children served in the program. This

program is a proven way of bringing disadvantaged children up to speed and preventing educational problems down the line. Despite the cost-effective nature of these programs, fewer than one out of every five eligible child has access to a Head Start Program.

Job Training Partnership

High employment is an avowed priority of this Administration, yet the Administration proposes a $700 million reduction for the Job Training Partnership. Young people who find it impossible to enter the workforce because of a lack of skills are well served by a program that provides meaningful training. In that these programs contribute to higher levels of employment, they pay for themselves by increasing the tax base, lessening the need for other social spending, and bringing individuals into the mainstream of society.

The Asbestos School Hazard and Abatement Act

In the past year, the federal government has distributed $50 million for asbestos abatement. This is an important step towards helping school districts deal with this serious health threat. Since that time, school districts needing assistance have applied for more than $500 million for abatement projects. Clearly, removing the health threat of friable asbestos in classrooms throughout the country is more cost effective than dealing with the health consequences of leaving it intact. Since

asbestos is a proven threat to safety and that school districts have extreme difficulties in dealing with this problem in existing budgets for physical plants, the Administration's to terminate this program is dangerously shortsighted.

Conclusion

Mr. Chairman, it is your Committee's responsibility to take the first step in determining our government's priorities for the coming years. Since 1981, these priorities have been sadly out of kilter. Defense spending has more than doubled, while investment programs such as education have made major sacrifices. We have heard countless lectures on the need for austerity to reduce the deficit. Yet we watch vital funding for education programs shifted into programs that threaten -- rather than ensure -- our security. Without a strong system of public education, there can be no national security. There can be no progress in any area.

The Department of Education points proudly to rising test scores in college entrance exams, to higher reading levels in other areas, to one educational accomplishment after another in every geographic area and in all economic strata.

This progress is not the result of Administration rhetoric, but of the success of the very programs the Administration proposes to reduce. This progress is the direct result of an educational partnership of federal, state, and local governments which have

worked together to provide funding, ideas, and initiative to make progress in the goals of academic excellence and equity.

We can find solutions to the problems that face us. We can create new opportunities for growth and prosperity. We can bring up the quality of life for all Americans. But like any enterprise it will take a sound investment.

Public education is such an investment.

The NEA asks that you lead this country into a future filled with promise by providing adequate support. We urge you to reject the President's budget, to safeguard education from any further cuts, and to assure than need-based programs such as Chapter 1 are able to maintain a level equivalent to current services. With adequate federal support, we can provide a system of public education that is more than adequate. We can provide excellence.

Thank you.

The CHAIRMAN. Thank you very much, Ms. Futrell.

Vince Sombrotto, who is representing the Fund for Assuring an Independent Retirement, an organization known as FAIR. Mr. Sombrotto, it is good to see you. Thank you for the leadership you have been providing as well.

STATEMENT OF VINCENT R. SOMBROTTO, CHAIR, FUND FOR ASSURING AN INDEPENDENT RETIREMENT (FAIR)

Mr. SOMBROTTO. Thank you, Mr. Chairman.

On behalf of the more than 2 million members represented by the FAIR coalition, I want to personally thank you for calling these hearings on the administration's budget for fiscal year 1987.

Most of the proposed cuts for fiscal year 1987 have been submitted by this administration before and rejected by the Congress several times. I might add that looking over on my righthand side, the fact that there are no representatives from the other side speak more eloquently than any of us about the President's budget and their inability to sit here and take the opportunity to defend it.

In the State of the Union, the President painted pictures of an increased individual wealth in America's massive recovery, yet reality tells quite a different harsh tale for the Nation's Federal and postal employees and retirees. His fiscal year 1987 budget uses deceit to hide tax increases and cloaks itself in rhetoric to cover attacks on our retirement and health benefits.

Our 2.2 million active and retired persons were both stunned and outraged when President Reagan called their retirement and health benefits the "fat" of the Federal budget. Reducing our annuities after years of devoted public service is not cutting the fat out of the Federal budget. The premium that ensures health care for our children is not the fat in the Federal budget.

The President also promised to stop anyone from trying to cut the heart out of our family's budget. Mr. President, your budget proposals stick a dagger in the heart of the Federal and postal person's family budget, sticks a dagger in the heart of the civil service retiree's family budget, sticks a dagger in the heart of our employment. You seek to place an additional burden on the postal and Federal employee's families.

Our members entered the Federal workforce with certain commitments from their employer with respect to pay, retirement, health benefits, in exchange for a lifetime of service. The employees have not reneged on their end of the bargain but the Chief Executive of this Nation has continued his relentless campaign to undermine us.

What does the Presidential promise of no tax increase mean for us?

The average Federal or postal employee will lose approximately $5,000 through an additional 2 percent tax for retirement, higher health premiums, and arbitrary changes in retirement benefits. These proposals make a mockery of the President's proposed 3 percent increase next January for Federal workers, while he gives on the one hand an inadequate pay increase, he takes much more away with the other hand. He should practice that trade on the sidewalks of New York. I see the mayor was just here. There are

great practitioners of the shell game in New York. It seems that the President when he leaves office could have a substantial income in that regard if he wants to follow that.

The history of Federal pay under the Pay Comparability Act is a history of broken promises. Federal workers lag behind every significant economic indicator including private sector wages, inflation, military pay, and State employee compensation.

The average retiree annuity is less than $1,200 a month of fully taxable benefits. The civil service retirement COLA, which President Reagan has turned into a movie of yesteryear, has been criticized as overgenerous. Its absence has forced civil service retirees to swallow 65 percent of the inflation occurring over the past 3 years. The Gramm-Rudman-Hollings COLA loss cost them $446 on January 1, 1986. Now the President proposes to cut it again next year.

President Reagan proposes to raise health insurance premiums, cancel the retiree COLA in 1987 and introduce a reduced COLA beginning in 1988. Even the Coca-Cola Co. realized that you shouldn't introduce new COLA's. [Laughter.]

This would result in a $2,000 loss per employee. Under the proposed CPI minus 2 percent formula, individuals retiring last year at age 62 would lose 25 percent of their purchasing power by the year 2000, when they are 77. Can you imagine the impact on the average civil service annuitant who would be faced with a reduction from $1,200 a month to $900 a month in real value?

As you know, Mr. Chairman, our retirees earned their annuities the hard way, with years of dedicated service. The average retiree receives approximately $1,200 a month. The Hay-Huggins study commissioned by the Post Office and Civil Service Committee which studied private versus public sector pay and benefits, showed that overall compensation in Federal and postal service lags 7.2 percent behind the private sector.

Our retirees do not enjoy the tax-free status of General Dynamics, W.R. Grace, or hundreds of other corporations. Unlike corporations, our taxes have not fallen dramatically after the 1981 tax cut. The President shows boundless compassion toward defense contractors. He should consider amnesty for civil service retirees who served their Government admirably for 30 or more years.

President Reagan, live up to your promise. Stop trying to cut the heart out of the family budgets of America's Federal and postal workers. In your own words, "It is time we left the family budget alone."

The President's budget also attacks our health benefits. Reagan rhetoric promised to provide affordable insurance for those whose life savings would otherwise be threatened when catastrophic illness strikes, but his budget proposed reducing health insurance and Medicare coverage.

Let's also look at the truth behind the Reagan proposal to create a ladder of opportunity to full employment. His budget proposes selling of Government assets, including some postal services and property. He has mesmerized by ideology. He insults Federal employees who have served the American people well. Those are code words for contracting out, postal deregulation, and union busting.

The President doesn't care about our jobs or quality of Government service.

Mr. Chairman, this President is the new Houdini, presenting smoke and mirrors, even in a time of national tragedy. The loss of the space shuttle *Challenger* crew is tragic. Many of the NASA astronauts are covered by civil service and are dedicated Government employees, not the faceless bureaucrats on the banks of the Potomac who the President likes to scapegoat.

Yet, even as the President spoke about America's grief, he crafted a budget which would deprive the surviving civil service spouses full benefits before age 65. Most spouse survivors' annuities are less than $600 a month. The survivor annuity is capped at a maximum of 55 percent of the employee's basic annuity. That's near poverty level. Yet the President would reduce it further through COLA elimination in 1987.

The national budget is clearly a statement on values. We need to invest more in human capital and less in Star Wars schemes. Yet the administration's budget makes the Orient Express a priority. This is unbelievable. Do we really need a plane to fly businessmen from Washington to Tokyo in 2 hours while surviving spouses are forced to run the family budget at near poverty level?

Decoding the budget rhetoric of this administration is simple. "Defense" means adolescent fantasies such as Star Wars. "No tax increase" means tax reductions for the rich but higher taxes for Medicare, health insurance, and retirement benefits. "Helping the poor" means closing down homeless shelters and job training programs. "Renaissance in education" means abolishing student loans and aid to education. "Privatization" means a fire sale equivalent to selling the house to pay the mortgage. The President's actions certainly speak louder than his words.

Congressmen, I do not believe in rhetoric covering reality or in form hiding substance. I will fight this President's budget personally and mobilize FAIR in the battle.

Thank you. I would be happy to answer any questions.

[The prepared statement of Mr. Sombrotto follows:]

PREPARED STATEMENT OF VINCENT R. SOMBROTTO

Mr. Chairman. My name is Vincent R. Sombrotto, chairman of FAIR, the Fund for Assuring an Independent Retirement, a coalition representing 28 organizations with over 2 million Federal and postal employees and retirees.

I want to personally thank you for calling these hearings on the administration's budget proposals for fiscal year 1987. Most of the proposed cuts for fiscal year 1987 have been submitted by the administration and rejected by Congress several times. In the State of the Union, the President painted pictures of increased individual wealth and America's massive recovery. Yet reality tells quite a different, harsh tale for the Nation's Federal and postal employees and retirees. His fiscal year 1987 uses deceit to hide tax increases and cloaks itself in rhetoric to cover attacks on our retirement and health benefits.

Our 2½ million active and retired persons were outraged when President Reagan called their retirement and health benefits the "fat" of the Federal budget. Reducing our annuities after years of devoted public service, is not cutting "the fat out of the Federal budget." The premium that ensures health care for our children is not the fat of the Federal budget. A fair wage for Federal workers is not the "fat" of the Federal budget.

The President also promised "to stop anyone trying to cut the heart of your family's budget." Mr. President, your budget proposals stick a dagger in the heart of the Federal and postal person's family budget; stick a dagger in the heart of the civil service retiree's family budget; and stick a dagger in the heart of our employment.

You seek to place an additional burden on the postal and Federal employee's family. Our employees entered the Federal workforce with certain commitments from their employer with respect to pay, retirement and health benefits in exchange for a lifetime of service. The employees have not reneged on their end of the bargain, but the Chief Executive of this Nation has continued his relentless campaign to undermine us.

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Reagan proposes to raise health insurance premiums, cancel the retiree COLA in 1987 and introduce a reduced COLA beginning in 1988. This would result in a $2,000 loss per employee. Under the proposed CPI minus 2 percent formula, individuals retiring last year at age 62 would lose 25 percent of their purchasing power by the year 2,000, when they're 77. Can you imagine the impact on the average civil service annuitant who would be faced with a reduction from $1,200 per month to $900 per month in real value?

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Congressman, I do not believe in rhetoric covering reality, or in form hiding substance. I will fight this President's budget personally and mobilize FAIR in the battle.

I will be glad to answer any questions you may have.

Mr. CHAIRMAN. I want to thank all of you. I think your testimony has been very straightforward. I have had a chance to peruse some of the more detailed testimony that you have given.

I would like to say that as I look at the figures, Mr. McEntee, that you put on the board, with regard to each of those States and also the published report, I am astounded by the significant losses that States are going to take. I know when I look at my own State, which is also your home State, I just do not know how the State legislature is going to make up for those losses or how local government is going to make up for those losses.

I just had a meeting, when I stepped out earlier, with the mayor from Louisiana, who said "Look, we are not using this money to provide for any programs that one could say are not essential, we are using our money to pay policemen to protect the city, and if you take away revenue sharing, you are not talking about some community center closing down or some recreation center, you are talking about cops not being out there to protect citizens."

I want to thank AFSCME for the very detailed breakdown which I think will be very helpful in deliberations.

Mr. Sombrotto, I totally agree with you with regard to what has happened with our Federal employees over the last couple of years, the freezes, the tax on retirement, and benefits. I think I can say without fear of contradiction, that I don't believe Congress, at least the House, is going to support those kind of priorities. I appreciate your testimony.

Ms. Futrell, I just want to thank you. I want to ask one question. In his state of the Union speech, the President alluded to an increase in the SAT scores or basic test scores and implied that was a result of his administration's policies, that suddenly there had been a significant demonstration of excellence in education. I would underline "implied." He did not explicitly say "I take credit for it." Clearly as he was talking about accomplishments of his administration, he said we are back to basics in education and excellence and the scores are up.

As the head of NEA, educators all over this country, what is your comment? Can he take any credit for any of that?

Ms. FUTRELL. No; I do not believe the President can take credit for the increase which we have seen in the SAT scores over the last 3 years. I think his comment was indicative of what we have come to expect from the President, and that is he is famous for taking credit where credit is not due.

The increase, I believe, in the SAT scores, is a result of the programs which we have in place such as chapter 1, Head Start, Follow Through, et cetera, programs which he has been cutting for

the last 5 years. If you look at the students who take the SAT tests, we are talking primarily about juniors and seniors in high school. These are students in many instances who have gone through the Head Start Program, the Chapter 1 Program, and as a result, they have received a better education.

We can also look at some of the scores which are now coming out which show that as the President has cut those programs, 9- and 13-year-old children's scores are beginning to go down.

I think the legacy the President will really leave is that of jeopardized educational achievement. When we look at the children who are in chapter 1 now, for instance, as he leaves office and they become of age to take the SAT, we are going to find they are not performing as well because he has cut that program so drastically.

He cannot, in my opinion, take credit for the current increase. That credit must go to the teachers. I think the credit must go to the reform movement which started way back in the mid-1970's. The credit must go to people like you and the other Members of Congress who recognized the value of programs like chapter 1 way back in the 1970's and 1960's. That is what has improved our SAT scores.

The CHAIRMAN. In other words, he was taking credit for stuff that was done in the 1970's and the effects were being felt in the 1980's. Because of the priorities that are being selected now, there will be a significant downturn. I appreciate that response.

Mr. McEntee.

Mr. MCENTEE. Mr. Chairman, if I could comment on your comment about Pennsylvania and what would happen to that State. Right now in Pennsylvania, we are undergoing a layoff of 300 people that work in the mental hospital system in the State of Pennsylvania due to the Governor's action and his crying need for funds. Even putting the people aside the people who are affected by the layoffs, although they are an extremely important part of the whole situation, it means he is removing 300 people from a mental health hospital system that now is ill-staffed and poorly staffed and with relatively few programs in the State of Pennsylvania.

You can multiply that in many States across this country. If in fact these cuts take place, it is not only the people that work in these hospitals, be they public hospitals in Cook County or mental hospitals in the State of Iowa or Washington or wherever, not only will those employees be affected but those people that desperately need those services in those hospitals will be very directly affected by these cuts.

The CHAIRMAN. Thank you, Mr. McEntee. I want to thank the panel. I am going to have to beg your indulgence. I am being called away to a meeting, an emergency. I will ask Mr. Lowry to take the chair. I will call on Mr. Williams of Montana, who is a member of our Education and Labor Committee, if he would be the first to ask the witnesses questions.

Mr. Williams, the gentleman from Montana.

Mr. WILLIAMS. Thank you very much, Mr. Chairman. It is nice to see each of you here today.

Mr. Sombrotto, let me first not ask a question but tell you something that I have told some of your member letter carriers and I

would like to tell them through you. I have to preface it with a short personal anecdote.

When I got elected here 8 years ago, I did it as other Members of Congress have done, by going door to door. We spent 2 years and went to 57,000 doors in western Montana. We heard everything. We heard complaints about almost everything. We kept track of everything people said to us at their doors because I wrote them a personal letter afterward. We kept track of it all and then cataloged it. Now, I want you to know something.

We didn't hear one single complaint about American letter carriers. In 2 years, we went to 57,000 doors. Whenever we heard anything about the letter carriers, it was always good. I know sometimes your people wonder if the delivery they provide to America is appreciated. Let me tell you, in western Montana, it is appreciated. Your people are the smile on Government's face. We hail you for doing such a good job.

Mr. SOMBROTTO. I appreciate that very much, Congressman. I will certainly alert our members, not only in Montana, but in the rest of the Nation about those sentiments. We have a commercial playing around the Nation about our letter carriers delivering for America. That is what we do, deliver for America.

Mr. WILLIAMS. Ms. Futrell, you and I are teachers together. I share your concerns about the President's budget this year as we have shared them together over the past half a decade. I wonder if you would be willing to do something for this committee?

As the chairman of the Human Resources Subcommittee or task force of this Budget Committee, I am trying to pull together some cost-benefit analyses, good hardheaded cost-benefit analyses, analyzing Federal spending. I would like to work with you and your people to determine a cost-benefit analysis of education spending over the last quarter of a century in this country.

We hear a great deal how Government should be run like a business. Fortunately and unfortunately, it is. Like business, the Government has an enormous debt. Like business, the Government is interested in investing where it is going to get the biggest return for its money.

One of the things this Budget Committee needs to know but does not really have the facts about, is with which investments do we get the biggest return for our dollar.

I hope you will cooperate in this effort. I will be in touch with you and your other people who I see almost every day, so that we will be able to work together. As for education, we are going to leave the work to you and your colleagues in this area.

Ms. FUTRELL. Congressman, we would be very happy to work with you to try to determine the costs/benefits regarding funding spent on education. Just to give you an example of what I think we are going to find, there was a study done several years ago, and I believe it was done by Congress itself, and what that study showed was that for every $1 we invest in education, there is a return to the American people of $6. I would assume that is even more positive as we move toward the future.

We would be very happy to work with you.

Mr. WILLIAMS. I appreciate that. We will be in touch with you.

Mr. Chairman, it is an interesting thing in this matter of running the Government when one begins to look at how Government runs like a business, if it does at all. In doing so you find some startling facts. You find that the debt in items of the private sector, industries and businesses' debt is far greater than the Federal debt. You find something that I think is remarkable. The Federal Government pays its debt back faster than does the private sector. The private sector pays its debts back on 10- and 20-year notes and the Federal Government pays most of its debt back on 3-year notes. If we can do a good job on this analysis, we are likely to come up with some very shocking things about running the Government like a business, perhaps that we should start running businesses like a government. [Laughter]. [Applause].

Mr. McEntee, I say this at a rather awkward time because I know that conversing across these tables is not the way to visit personally. But I want you to know how much I appreciate the personal friendship of your people toward myself and also the common interests we share together in Montana. When I was in the Montana Legislature, collective bargaining was my legislation for your people in Montana. We have been close friends ever since. As Montanans, they have shown time and again their respect toward the letter carriers. They have also shown that their State, county, and municipal employees do a good job and are respected.

Your members have the same problem that Vince's do. They would like some of that respect to show up in their paycheck occasionally as would the teachers.

Nonetheless, from my standpoint, we think you people do a good job out there and we appreciate it.

Mr. McEntee. Thank you for the comment. We don't often hear it.

Mr. Williams. Thank you, Mr. Chairman.

Mr. Lowry [presiding]. Thank you. There is a bank called Seattle National Bank, over 100 years old, and it went bankrupt last year.

The gentlelady from California.

Mrs. Boxer. I do not have any questions, but would like to make a comment about the whole idea of Federal employees and what they mean to the country and what they should mean to the President.

When the terrible tragedy occurred on the *Challenger* and the President united the entire American family with his comments, I could not help but think, Who are these astronauts? What are they? They are Federal employees, who are the people who are out there enforcing drug laws, enforcing toxic waste laws, and they sometimes get into some very dangerous situations as Federal employees. Not every single Federal employee is in the line of fire. I am not indicating that. They serve their country and in many cases with bravery. We are not even talking about the military side of the budget. We are just talking about the civilian side of the budget right now.

I think it is very important that the President understand that when he knocks Federal employees day in and day out, basically through his administration, which is what they have been doing, through their proposals which cut at the heart and soul of morale, and I know that is true, that to make a wonderful speech, that does

not make up for it. He has got to understand what he has been doing.

I have been interviewing some people who came into Government service during the days of John Kennedy, to get the feeling of why they came. They have such a wonderful feeling of what it was to really serve their country. In fact, this was something they were doing with spirit.

I think we are losing that to a great degree. With all the talk about how great America is and America is the greatest country in the world, with all the talk about America and all the flag waving, who stands behind us? Who stands for America? It seems to me that we have to start fighting back. I think in this budget, as I said before, we are really fighting for the hearts and minds of the American people.

We are going to need your help to do that. I commend you for your forthright statements. I urge you to fight on. You certainly are not alone. Someday, the winds will change and we will be back where we were before, giving dignity to people who serve in the classroom, dignity to working men and women, not only in Federal service but from without also.

Mr. WILLIAMS. Would the gentlelady yield?

Mrs. BOXER. Yes, I would be happy to.

Mr. WILLIAMS. Mr. Chairman, have any of our colleagues from the minority side attended our hearing today?

Mr. LOWRY. None.

Mr. WILLIAMS. I ask because you have been here throughout, and I had to leave a couple of time and meet with some folks in the back. I don't know why our Republican colleagues, who have obvious concern about the appropriate conduct of the public's business, would boycott a hearing, and it has obviously been boycotted, at which the representatives of the people who labor in the public field are here to give us their best advice as to how we should draw this budget.

I don't say this in a partisan way, but I think that people who work for the public in this country should be outraged that they have been boycotted as they have come here to give us the best advice they can about how the budget of this country should be structured.

Mr. SOMBROTTO. If I may, they do it with good reason, because their position, their administration's position, is indefensible, and they just do not have the courage to sit up there and try and respond to the statements that we have made. And so I can understand why they are boycotting this.

Mr. MCENTEE. One comment. When we don't show up for work, we don't get paid. [Laughter.]

Mr. LOWRY. I have a question that I would like to ask each of you.

Mr. McEntee, revenue sharing, of course, is a major issue before us, and as you know, the authorizing committee, subcommittee, moved a revenue-sharing bill. My question is, if we can get some reauthorization, should we look at a tighter formula for targeting, or should we look at reducing—not changing the formula, just plain reducing the amount?

Mr. McENTEE. I guess, Mr. Chairman, if we had our druthers, we would not like you to do either. But if we don't have our druthers, I think that probably targeting would be more appropriate than a reduced amount throughout.

In days gone by, the Congress and then the President signed a countercyclical piece of legislation which was—first of all a very interesting piece of legislation and a very helpful piece of legislation in terms of the levels of local government. There are States out there right now and there are cities out there, even though we talk about recovery, we talk about the fact that unemployment now is below 7 percent, but it has been, as you well know, a very spotty recovery. It is by far not a national recovery, and we have States and we have levels of local government, indeed, that are in dire trouble.

Your State is not in real good shape as is the State of Iowa, the State of Minnesota, the State of Wisconsin. You can go out through the farm belt, and those States and all of those levels of local government, indeed, are not in real good shape.

Without really having a chance to analyze this subject, we would probably opt for targeting that would be based on some kind of formula having to do with need and particular levels of local government.

But the mayors were so right when they talked about revenue sharing. We have sat in meetings with the mayors and the people on the local scene, and these moneys are not frills. They pay for cops, they pay for firemen, they pay for very direct public services at all levels of local government. If they don't get it, they do not get the revenue sharing either, that service is gone, or they will be banging on the doors of the State legislatures, and they essentially do not have money. If the cuts go through, they may raise the most regressive set of taxes in America, such as the property tax, to do something about it.

We would only hope that the Congress of the United States, in its wisdom, would continue with a very needed and a very critical program for the local levels of government.

Mr. LOWRY. Steve stays in touch with it all the time, so I am sure that we will be continuing this.

Mr. McENTEE. He will get paid for the day, then. [Laughter.]

Mr. LOWRY. Ms. Futrell, the note the staff gives me is that the CBO estimate of the President's recommended budget is about a $2.2 billion or thereabouts reduction in the Department of Education from $17.7 to $15.3 billion. I think you have been quite clear as to the effects of that on the future of this country. But we, in a couple of weeks, are going to try to come out of here with some numbers.

What do you think the number is, in the political reality of what we have, that we ought to place for the function of education?

Ms. FUTRELL. If you ask for my candid opinion as to what the number should be, I will say that we should have the funding at the real level that it was prior to this administration taking office. I think a lot of people fail to realize that education has borne a disproportionate share of the cuts over the last 5 years. Now we are being asked to absorb some more. We have lost about one-third of

our funding, if you look at inflation, et cetera, as part of the total picture. Now we are being asked to absorb even deeper cuts.

This country has to make some decisions, Mr. Chairperson. The children who are in our schools today will be the future workers and leaders of this country. If we do not educate them—and I believe that they will need a better education than any generation we have ever had—if we think we have problems now, we have not seen anything.

To just give you an example, I was reading a statistic not long ago which said that in 1970, for every person in retirement, we needed about 15 workers. Today, that number is down to about 3.5. By the year 2000, it is going to be down to 1.5.

I would say to you that we need to fully fund educational programs. We must not continue to cut these programs, because the children are the future of this country.

We oppose Gramm-Rudman-Hollings. We oppose the President's budget. We believe that the preferences they offer are choices of whether you prefer to have your arms cut off or your legs cut off. We do not prefer either. We prefer to make sure that the children of the country have the education that they need to do the job that they will have to do in making hard choice in the future. And that is an investment in this country.

Mr. LOWRY. What about a freeze?

Ms. FUTRELL. Well, we would prefer not to have to deal with a freeze, because as I said a moment ago, we already have absorbed 25- to 30-percent cuts over the last 5 years. However, we recognize that we might have to face that as a reality. We certainly would prefer the freeze over additional cuts.

Mr. LOWRY. Thank you.

Mr. Sombrotto, I think you make your point well when you talk about the Federal postal retirees paying taxes on their retirement, and, of course, what you are referring to is that the vast majority of Social Security benefits is not taxed. And I think you said the average is $1,200 a month; is that what you said, $1,200 a month?

Mr. SOMBROTTO. Yes.

Mr. LOWRY. Thank you. I think you make an awfully good point.

Do you know, with your committee, what the average is on which people would start paying taxes? In other words, because of our tax system not as progressive as it should be but somewhat progressive tax system, there is a level under which nobody is going to pay any taxes, and if you're retired, with the double deduction, that level is a little higher. Do you have figures on the average of when people start paying taxes relative to this retirement question?

Mr. SOMBROTTO. No, I don't, but I'd be glad to develop those numbers for the committee. That wouldn't be any problem.

But I would hasten to add that there are—25 percent of all retirees are survivor annuitants, and about 75 percent of them are women, and their annuities are below $6,000 a year, and that's below the poverty level. And so obviously, they won't be paying taxes. But I can get the numbers that you require.

Mr. LOWRY. I think that would really be helpful. I'm a person who has been advocating the correct approach to Social Security is

absolutely not to freeze the COLA because of the low income. But anyhow, I think that would be very helpful from that standpoint.

Now under Gramm-Rudman, do you see any way that the Federal retirees are going to get a COLA?

Mr. SOMBROTTO. Sure; if the Congress acts in that way, and we're going to support H.R. 4060, and we'll get a chance to restore COLA.

But let me just say this, and certainly I don't want to be misinterpreted, what I'm about to say, our union and the members of our union stand for decent retirement for all folks. We certainly support Social Security, always have, and will continue to do so.

But there is something unfair about the fact that Social Security recipients receive cost-of-living increases and Federal and postal retirees will not. And our members view that as an inequity.

Now we don't want to bring Social Security down to us. We want to get back to where we were, so that everyone should be treated fairly, and as you know, last year the Congress promised that they would treat both of us in the same manner.

That hasn't happened, and it's difficult for our folks to understand that and reconcile that. So we're going to be pressing you very hard, all of the Members of Congress, to rectify that inequity.

Mr. LOWRY. Well, thank you very much. I want to thank the panel. Mr. Williams.

Mr. WILLIAMS. I would not be taking this time if the Republicans were present, and I know there are a lot of other people here who have questions. But, Mr. Sombrotto, I didn't understand what you were telling us about the percentage of your annuitants who receive less than $6,000 a year.

Mr. SOMBROTTO. Yes, that's a survivor annuitant. Each Federal and postal employee has an option to make a survivor a survivor annuitant by paying a percentage of their annuity—that is, deducting a percentage of their annuity, so in the event that they predecease their survivor, that their survivor gets an annuity.

That annuity is based on 55 percent of what that annuitant was receiving at that time. And so many of them get less than $600 a month.

Mr. WILLIAMS. What percentage receive less than $6,000 a month? Did you give us a percentage?

Mr. SOMBROTTO. About 25 percent of all survivor annuitants.

Mr. WILLIAMS. Receive less than $6,000.

Mr. SOMBROTTO. Less than $6,000 a year.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Mr. LOWRY. I want to thank the panel on behalf of the committee. It was very helpful and excellent testimony. I want to thank the people that you have work up here. They stay in good touch with us. Bob is in my office all the time and George, and I appreciate that very much. Thank you.

[The following additional material was submitted for the record:]

CONGRESS OF THE UNITED STATES,
Washington, DC, February 14, 1986

Hon. WILLIAM H. GRAY, III,
Chairman, House Budget Committee

DEAR BILL: I bring to your attention and ask for your consideration and inclusion into your hearing record the views of my constituent, Mr. James D. Bernard, a bee-

keeper from my congressional district. Mr. Bernard has expressed his concerns about the effect of the Gramm-Rudman statute on the honey price support program.

Your consideration of his concerns, and inclusion of them in the committee's hearing record, would be most appreciated. Any information which I may provide to Mr. Bernard about the fiscal year 1987 budget outlook with regard to agricultural support programs would be helpful. Thank you.

Sincerely,

JOHN BREAUX, *Member of Congress.*

BERNARD'S APIARIES INC.,
Breaux Bridge, LA, January 14, 1986.

Hon. JOHN R. BREAUX,
211J Rayburn House Office Building, Washington, DC.

DEAR CONGRESSMAN BREAUX: Once again we wish to thank you for your support. We appreciate your vote for the Honey Loan Program in the recent session during which the Farm Bill was debated.

We are concerned about the Gramm-Rudman Bill and the possibility that it could eliminate the Honey Loan Program. We are asking you to exert your influence to prevent this from happening.

Our organization, The American Honey Producers, is proposing that any cuts made by this bill should be made across the board, rather than to one particular program. We hope that you will continue to support our industry. The Honey Loan Program, even though it is being fazed out, is extremely vital to the beekeepers of the nation. We know you are aware that pollination is the lifeline of agriculture. Thanks for your assistance.

Sincerely yours,

JAMES D. BERNARD.

PREPARED STATEMENT OF E. PHILIP RIGGIN, DIRECTOR, NATIONAL LEGISLATIVE COMMISSION OF THE AMERICAN LEGION

Mr. Chairman: The American Legion has reviewed the President's fiscal year 1987 budget proposal for the Veterans Administration, and our organization finds the proposal to be deficient in several principal areas. We strongly encourage you and your Committee colleagues to critically examine this spending plan and to approve the restoration of essential funds as you develop the concurrent budget resolution for fiscal year 1987.

We invite your particular attention to the following accounts in Function 700, categories in which we believe remedial action must be taken by your Committee.

MEDICAL CARE

The most obvious deficiency in the Administration's request is its failure to provide for an adequate level of medical personnel to operate VA's health care delivery system. By citing concepts such as "productivity growth" and reduced services for "low priority veterans," the plan seeks to eliminate more than 8,000 personnel. Official estimates show that this reduction would require cutbacks of 57,000 inpatient visits and 1.1 million outpatient visits during the next fiscal year.

We strongly object to this recommendation, and we urge you to approve sufficient funds to maintain a "current services" health care system with a personnel level at least equal to the pre-sequestration number for FY 1986. In our opinion, this is not an unreasonable request for a system in which cost containment has been consistently applied over the past 10-12 years.

In fact, since 1975 the cost of VA medicine has barely kept pace with increases in the Consumer Price Index. It, therefore, has fallen far below annual percentage adjustments constituting the "medical CPI." Fiscal controls over that period have been sufficient to limit the cumulative percentage increase in VA health care spending to only one-third the percentage by which federal spending for Medicare has increased.

Our organization remains convinced that reduced VA medical services, in the face of increasing demand for those services, simply shifts that demand to other government-supported programs. Denying access to preventive health care (1.1 million fewer outpatient visits) is a potentially expensive idea in the long run when considering the number of future acute care episodes caused by less prevention.

BENEFICIARY TRAVEL REIMBURSEMENT

The Administration's plan to virtually eliminate all travel expense reimbursement to veterans being treated at VA facilities is a recommendation that deserves your close attention. It is our firm belief that hundreds of thousands of regular VA patients rely heavily on this reimbursement, especially those veterans whose treatment plans require frequent outpatient visits. Perhaps, architects of the Administration's plan based part of their proposal on the assumption that terminating the reimbursement procedure would reduce inpatient/outpatient demand and, in turn, would accommodate the elimination of medical personnel.

CONSTRUCTION OF VA MEDICAL FACILITIES

The Administration's budget proposal calls for an approximate cut of $200 million in VA construction funds when compared to fiscal year 1986. It includes no funds for VA nursing home construction during the next fiscal year.

We fully endorse the replacement and modernization projects identified in the proposed construction plan; however, we are concerned that a reasonable pace of replacement and modernization cannot be maintained within the funding limits of the administration's plan. At the very least, we recommend the restoration of nursing home funds for the most critically needed facilities, as well as design funds to facilitate major replacement and modernization projects in fiscal year 1988. As you know, the Veterans' Affairs Committee is currently examining future construction recommendations for the purpose of developing a list of project priorities. We, therefore, encourage you to consult with the Veterans' Affairs Committee before setting budgetary guidelines in this account.

VA HOME LOAN PROGRAM

Our organization strongly objects to the Administration's proposal to increase VA's home loan user fee by 280 percent over the next 4 years, the first installment of which would be a 100 percent increase in fiscal year 1987. We remain convinced that the fee increase would dramatically reduce program participation, especially in high housing cost areas where down payments are routinely required along with other origination fees or similar costs.

It has been officially determined by VA that the program will be self sustaining in fiscal year 1987; thereby removing the need for an appropriation to bolster the loan guaranty revolving fund. If the program is allowed to operate without additional impediments, such as an increased user fee, receipts generated by the existing fee are expected to approach $180 million this fiscal year and a similar amount during fiscal year 1987.

We, of course, continue to support necessary legislative and administrative remedies to (1) reduce the default/foreclosure rate (2) speed the disposition of VA-repossessed properties (3) facilitate refinancing of existing high interest loans and (4) implement more effective mortgage insurance procedures. It simply makes sense, from the veteran home buyer's perspective and the federal budget perspective, to let the program proceed as unfettered as possible. Assuming prudence during the loan qualification process, the home loan program is on the verge of making major contributions in the economy—for home builders and associated tradesmen, for real estate companies, and for lending institutions.

Mr. Chairman, the President's VA budget plan for fiscal year 1987 contains other items which cause us concern. Rather than identify each of them, we wish to express our firm belief that expenditures for veterans benefits and services over the past decade present a model of fiscal constraint when compared to virtually any other Federal spending initiative over that period. During the past 10 years the cumulative increase in VA spending has been limited to 55 percent, only one-third the rate of all Federal spending increases since 1976.

For this reason, one that can be reinforced by more specific comparisons between VA accounts and those of other Federal agencies, we believe that your committee's decision on Function 700 should recognize two things. First, the architects of veterans programs on and off Capitol Hill have designed and refined a package of benefits and services that cost-effectively meets the needs of veterans. Second, additional cuts, particularly in discretionary VA accounts, will begin to destroy the integrity of services rendered and, as previously mentioned, elimination of some of those services are not likely to result in any net governmental savings.

Your attention to and consideration of our organization's views are appreciated.

PREPARED STATEMENT OF STEPHEN L. EDMISTON, DEPUTY NATIONAL LEGISLATIVE DIRECTOR, DISABLED AMERICAN VETERANS

Mr. Chairman and members of the committee, on behalf of the more than one million members of the Disabled American Veterans and its Ladies Auxiliary, I am pleased to have this opportunity to discuss the budget request for the Veterans Administration for fiscal year 1987.

Let me begin by thanking you, Mr. Chairman, and the members of the committee for permitting us to present our views on the fiscal year 1987 VA budget request prior to completing your work on the First Concurrent Budget Resolution.

Before specifically addressing the VA's proposed fiscal year 1987 budget request, Mr. Chairman, we believe that is is important to point out that the obvious driving force that has shaped this budget is the Gramm/Rudman/Hollings balanced budget amendment. Not only has Gramm/Rudman/Hollings influenced the make up of the fiscal year 1987 budget request, but is has also inflicted direct benefit reductions on deserving service-connected disabled veterans, their dependents and survivors in the current fiscal year.

Therefore, as the committee considers the VA's fiscal year 1987 budget proposal, we urge you to fully consider taking appropriate actions to insure that VA programs and benefits that impact directly upon service-connected disabled veterans and their dependents are protected from the provisions of Gramm/Rudman/Hollings.

As you know, Mr. Chairman, on behalf of the Veterans Administration, the President is requesting $26.6 billion in budget authority to administer the various programs and services for millions of our nation's veterans and their families in fiscal year 1987.

In budget authority, the VA request is approximately $408 million below the fiscal year 1986 level, primarily due to so called "projected savings" that include:

Staffing reductions of more than 8,900 health care professionals;

A substantial decrease in the number of veterans treated as inpatients and outpatients;

Substantial reduction in construction funds;

An incremental increase from 1 percent to 3.8 percent in the user fee charged to VA guaranteed home loans;

Seeking no funding for the Veterans Job Training Program;

Repealing the VA's authority to grant education loans;

Closing the All Volunteer Force GI bill to new enrollees;

A change in eligibility criteria for the VA plot allowance.

Overall, Mr. Chairman, these projected savings, coupled with other budget proposals and the Gramm/Rudman/Hollings sequestering order to become effective March 1, 1986 will clearly jeopardize the VA's ability to provide continued quality care at every medical facility in the VA health care system.

MEDICAL CARE

The fiscal year 1987 budget request calls for an overall decrease in funding in the VA's medical care account of $46.1 million below the fiscal year 1986 level.

At first glance, Mr. Chairman, it would appear that the funding reduction for VA medical care is quite small, however, when you look beneath the surface and examine the budget documents for the VA's medical care funding proposal, you discern an entirely different picture.

For example, the VA proposes to: treat fewer "low priority" veterans; reduce medical care personnel by 1 percent; and nearly eliminate beneficiary travel.

By so doing, they would reduce the number of medical care personnel by more than 8,900 and save over $500 million.

Furthermore, the loss of more than 8,900 medical care personnel translates into the loss of more than 1,300 nurses and 500 doctors and dentists, as well as other health care personnel.

As a result, the VA will treat fewer (so called) "low priority" veterans by 62,000 inpatients and 1.2 million outpatient visits, and further reduce the overall number of VA hospital and nursing home operating beds by approximately 3,000 from the Fiscal Year 1986 budget level.

Mr. Chairman, the President's proposed Fiscal Year 1987 VA budget request blatantly ignores the provisions of Section 5010(a)(1), Title 38, USC—"The President shall include in the budget transmitted to the Congress for each fiscal year pursuant to section 1105 of title 31, an amount for medical care and amounts for construction sufficient to enable the Veterans' Administration to operate and maintain a

total of not less than 90,000 hospital and nursing home beds in accordance with this paragraph . . .

The budget documents reveal that during fiscal year 1986 the VA will operate at least 900 beds below the statutory requirements and will seek to further circumvent the law by operating 4,000 fewer beds than the law requires in fiscal year 1987 . . . and at the same time they propose to cancel all new VA nursing home construction.

We must question, Mr. Chairman, why the VA (or OMB) is seeking such drastic reductions in VA medical care funding when their own statistics reveal they are turning away more than 30,000 eligible veterans who are seeking VA health care services each month.

In the past OMB has made it perfectly clear that they would like "to shrink the size of the system"—but is this their real effort or do they want to simply destroy the VA health care system?

As you know, Mr. Chairman, the VA health care system has been on a serious decline for a number of years due to negative (deflated) funding. The proposed fiscal year 1987 medical care budget request only exacerbates this chronic state that has existed for more than a decade.

Reduced medical care funding, coupled with such proposals as drastic reductions in health care personnel, decreasing the number of veterans treated, elimination of most beneficiary travel funds, reducing the number of available operating beds and providing no new funding for the Health Professional Scholarship Program, only serve to jeopardize the quality of health care provided at each and every VA medical facility.

We note, Mr. Chairman, that the VA is again proposing legislation to (1) repeal section 610(a), Title 38, USC—providing eligibility for hospital or nursing home care for a nonservice-connected disability if the veteran is 65 years of age or older—(2) establishing a means test for certain categories of veterans without service-connected disabilities and (3) provide authority for the VA to collect reimbursements from private health insurers of nonservice-connected veterans receiving VA health care services.

These legislative proposals, as you know, Mr. Chairman, were addressed by the House and Senate Veterans' Affairs Committees and are currently pending in the Omnibus Budget Reconciliation Act of 1985—H.R. 3128.

For the record, Mr. Chairman, the DAV remains opposed to the Administration's proposed means test. However, the DAV supports the medical care eligibility changes agreed to in H.R. 3128. These provisions, in our view, are a significant step to strengthen and enhance health care for all service-connected disabled veterans.

With respect to the proposal to authorize the VA to collect reimbursements from private health insurers—as proposed by the VA and contained in H.R. 3128—the DAV remains unconvinced the VA will in fact receive revenue in excess of the administrative costs of implementing and collecting these payments.

Mr. Chairman, we encourage you, and the members of the Committee, to carefully scrutinize the fiscal year 1987 funding levels proposed for the VA medical care program. We believe such scrutiny will lead you to recommend realistic levels of funding (unlike that proposed by the President) that will acknowledge the importance of providing timely, quality medical care services to the nation's eligible veterans.

CONSTRUCTION

The VA's fiscal year 1987 construction request is $465 million, some $332 million below the $797 million fiscal year 1986 level.

Mr. Chairman, while we support full funding of the VA's request for construction programs we are, quite frankly, seriously concerned that this type of construction request fails to adequately address the needs of the aging capital plant of the VA health care system.

Furthermore, while more and more elderly veterans are seeking nursing home care from the VA, this construction request reflects a new OMB mandated policy which directs the VA to shift the responsibility for VA nursing home care to state and community nursing facilities. As a result all new VA nursing home projects have been cancelled.

The VA's fiscal year 1987 budget request does contain, however, a $21.5 million increase (over the fiscal year 1986 level) in grants for construction of state extended care facilities. The VA's request of $42.4 million will provide for an additional 120 nursing home care beds, 126 convertible domiciliary/nursing home beds and 150 domiciliary beds.

As you know, Mr. Chairman, this particular federal/state sharing program has been a tremendous success in terms of encouraging states to actively participate in the nation's commitment to providing quality care to her eligible veterans. However, the DAV does not believe the federal government should relinquish its primary responsibility for veterans health care—especially in the nursing home care area.

Additionally, we have noted that the VA continues to reduce the number of medical, surgical and psychiatric beds, while at the same time providing modest increases in the number of intermediate and nursing home care beds, to include conversion of some existing hospital beds to nursing home care beds.

While the DAV does not object to some realignment of operating beds we trust an appropriate balance will be maintained to meet the acute, intermediate and long term health care needs of all eligible veterans.

Mr. Chairman, the VA construction request for fiscal year 1987 simply does not go far enough to allow the VA to accomplish what must be done if the health care system capital plant—which represents a multi-billion dollar investment on the part of the American taxpayer—is to remain viable.

PROPOSED LEGISLATION

The administration's fiscal year 1987 budget request proposes legislation, in addition to that which I have previously discussed, that would provide for (1) an increase of 3.7 percent in the rates of Disability Compensation and Dependency and Indemnity Compensation (DIC) effective December 1, 1986; (2) increasing the loan origination fee incrementally from 1 to 3.8 percent by 1990; (3) changing eligibility for the plot allowance so that it would be the same as the burial allowance; (4) repealing the VA's authority to make education loans; and (5) closing the All Volunteer Force GI bill to new enrollees and reopen the post Vietnam era Education Program.

The DAV is pleased with the Administration's proposed cost of living adjustment in the rates of Disability Compensation and DIC benefits—in recognition of the special consideration service-connected disabled veterans and their survivors should be given.

Accordingly, Mr. Chairman, the DAV supports the enactment of legislation that would provide disability compensation and DIC recipients with a cost of living adjustment in line with the rise in the Consumer Price Index effective December 1, 1986.

As noted, the Administration has again proposed increasing the home loan guarantee program users' fee incrementally from 1 percent to 3.8 percent by 1990.

We believe the Committee should carefully evaluate the adverse impact this proposal will have on Vietnam veterans, who are the primary beneficiaries of the program today and, should it be rejected, we respectfully request that the Department of Veterans Benefits be exempted from absorbing the funds associated with the proposed legislation.

However, as a result of the sequestering actions of Gramm/Rudman/Hollings that directly impact on the VA home loan program, and are scheduled to take effect on March 1, 1986, it would appear the entire home loan program is doomed for the remainder of fiscal year 1986 . . . unless Congress takes action to relieve the problem.

VETERANS EMPLOYMENT PROGRAMS

Mr. Chairman, we have also reviewed the proposed budget for veterans' employment and training programs administered through the Office of the Assistant Secretary of Labor for Veterans Employment and Training.

Before proceeding, however, I wish to express our disappointment with the Veteran Administration's failure to request funding for the Veterans Job Training Act for fiscal year 1987. The reasons cited by the VA for not requesting additional funds—(1) a significant drop in unemployment of Korean conflict and Vietnam era veterans and (2) the program unnecessarily augments job services for veterans by the VA and other government agencies—reiterates, in our view, the Administration's continued lack of support for this important employment program for veterans.

With respect to the Office of Assistant Secretary of Labor for Veterans' Employment and Training, the administration has proposed a fiscal year 1987 budget request of $13.1 million. This amount will fund 279 positions—a reduction of 3 from the current fiscal year authorized level of 282.

As you know, the Office of Assistant Secretary of Labor for Veterans' Employment and Training also has responsibility for distributing the funding for Disabled Veterans Outreach Program (DVOP) and the Local Veterans Employment Representative (LVER) program.

In this regard, the fiscal year 1987 budget proposes $69.4 million to support 1,894 DVOP positions. The LVER program, on the other hand, is slated for a reduction of more than $6 million from the fiscal year 1986 level. The fiscal year 1987 LVER budget request of $48.9 million will result in the loss of more than 200 full-time equivalent positions and, in our view, will definitely impact adversely on services provided to veterans.

Mr. Chairman, we are concerned that continued employment services to veterans may be reduced due to the overall decline in personnel system wide. In this regard we urge the committee to continue its support for full funding of the DVOP and LVER programs.

CONCLUSION

In closing, Mr. Chairman, in addition to the views we have already set forth with respect to the VA's proposed Fiscal Year 1987 budget request, I want to further emphasize and underscore our very serious concern for the VA health care system and the devastating effect this budget (if approved as proposed) spells for those eligible veterans who rely on the system for medical care.

We urge the Committee to favorably recommend to your colleagues in the U.S. House of Representatives levels of funding in the First Concurrent Budget Resolution that realistically and adequately address the needs of all programs administered by the VA.

Again, Mr. Chairman, I wish to thank you and the members of the committee for providing us this opportunity to express our view on this most important subject.

PREPARED STATEMENT OF R. JACK POWELL, EXECUTIVE DIRECTOR, PARALYZED VETERANS OF AMERICA

Mr. Chairman and members of the committee, I am R. Jack Powell, executive director of Paralyzed Veterans of America, and on behalf of the members of Paralyzed Veterans of America, a congressionally chartered veterans' service organization, I want to thank you for affording the opportunity to submit our statement for the written record.

PVA appreciates the committee's efforts to conduct hearings, and for being able to express our views and concerns regarding this most important issue, the administration's proposed fiscal year 1987 Veterans Administration budget.

All of PVA's members are veterans who have experienced catastrophic spinal cord injury or dysfunction, and it is on behalf of these veterans who have considerable contact with the VA's regional offices and medical centers located throughout the United States that we present our views today.

Mr. Chairman, the budget proposed for the Veterans Administration for fiscal year 1987 is, without a doubt, the most deplorable attack on veterans and the programs and benefits which have been established to meet their needs. In past years we have found shortcomings in proposed VA budgets, but never have we seen such a blatant abdication of the nation's responsibility to the men and women who have rendered service. This budget proposal is more than an effort to curtail federal spending and reduce the deficit, it is an overt effort to eliminate veterans' benefits and preclude veterans' access to needed services, particularly in the area of medical care.

The proposed budget purports to be a reduction of $408 million below the current year, including $234 million sequestered under the provisions of the "Balanced Budget and Emergency Deficit Control Act of 1985." However, upon examination of the proposals contained within the fiscal year 1987 VA budget, it becomes obvious that benefits and services for veterans will be reduced in excess of $1 billion. The budget proposal assumes the Veterans Administration will absorb the effects of inflation, the additional costs associated with cost-of-living increases in compensation, dependency and indemnity compensation (DIC), and pension, and salary increases for employees. All of these factors will drastically diminish the VA's capability to meet the requirements for adequately providing for veterans.

Over the past several years we have observed that budgets for the Veterans Administration were basically current services proposals, providing for no real growth in benefits and services. This year's budget proposal falls significantly below any such description and can be viewed only as an effort by this Administration to reduce the scope and availability of services and benefits for veterans. The Fiscal Year 1987 budget proposal for the Veterans Administration falls far short of meeting the current needs of veterans and fails miserably to adequately address future needs.

PVA recognizes the need to reduce the federal deficit, but in examining the proposed fiscal year 1987 VA Budget, we find the targeting of veterans' health care and services as a source of spending cuts and deficit reduction to be a reprehensible approach and disservice to the men and women who have served the nation.

Historically, this country has cared for its veterans. This huge task cannot be left to state and local governments which are not equipped for such an effort, and are already overburdened. The cost for providing for our nation's veterans is an obligation that is associated with the continuing cost of our national defense.

Mr. Chairman, this year, the Nation's 28 million veterans, and their 54 million dependents and survivors will have to rely more than ever upon the wisdom and energies of this committee, and Congress as a whole, to secure adequate funding for the programs and services administered by the VA. Repeatedly, Congress has had to struggle to add funding to proposed VA budgets that were patently insufficient to meet the needs of the nation's veterans, and the task this year will certainly be as challenging as any we have witnessed during the past several years.

The Federal budget that is submitted to Congress each year defines our nation's values and establishes the President's priorities. The nearly $1 trillion budget proposed for fiscal year 1987 represents a retreat from our commonly held values, disregards this nation's and Congress' approach for dealing with the deficit and certainly misplaces priorities. If the budget that was submitted to Congress were enacted, as proposed, more that $20 billion in additional reductions would be cut from already curtailed domestic programs that this administration has continually cut since 1981. At the same time, under the banner of national security, military spending would increase 8 percent, by more that $34 billion in budget authority.

We all share a concern and a commitment to national security, but simply throwing more and more money at the Defense Department is not necessarily going to provide Americans with the defense they expect. The scandalous abuses of military spending that have been uncovered in the past 2 years clearly demonstrate the inability of the defense community to exercise any efficiencies in effectively administering these increased levels of budgetary authority. Yet, to finance this relentless build up, the American people are asked to accept greater sacrifices and absorb deeper cuts in domestic programs.

The operating budget proposed for fiscal year 1987 for Veterans Administration is just one example of the many programs that have been offered up as sacrificial fodder. As former members of this nation's military service, veterans cannot and will not tolerate the continued reduction in benefits and services which this grateful Nation obligated itself to provide us. This obligation was not made under duress. It was not conceived as a great social program, it was provided out of appreciation for the service, the sacrifice and in many cases, for the personal injuries that we, as citizen soldiers incurred in defense of our nation's ideals. Now, under the guise of fiscal constraint, we veterans are supposed to be content with less than that which was promised. We are to forget our fellow serviceman, those who did not hesitate to give their full measure when asked to fight.

The Federal deficit problem is of concern to each and every American, veterans included, but the astronomical deficits that have accumulated over the past five years of the Reagan presidency are not of our doing and we are not willing to allow you or the administration to forget the obligations and responsibilities incurred by previously enacted legislation benefiting veterans, their families, and their survivors.

The Veterans Benefits and Services function of the Federal Government, as administered by the Veterans Administration, has increased by approximately 25 percent since 1980, with outlays rising from $21.2 billion to $26.4 billion in the 1987 budget request (House Budget Committee statistics). On the surface this amount may seem adequate, and compared to other nondefense related programs, veterans certainly have not fared as badly as most. Still, one must remember the more than 50-year mission of the VA, that being "to serve America's veterans and their families with dignity and compassion and to be their principal advocate in ensuring that they receive the care, support and recognition earned in service to this Nation."

This they have attempted to do over the years, but recently veterans and certainly you, as members of Congress must be wondering if the role of the VA has not been usurped by a small band of pencil pushing, number crunching, administration surrogates housed in the Office of Management and Budget, who without concern, save for spending a buck, coldly and dispassionately cut this program and that.

MEDICAL CARE

Mr. Chairman and members of the committee, the most devastating single component of the fiscal year 1987 VA budget proposal is in the area of health care. No VA service provided to veterans is more critical or important to their well-being, and in many cases, their very survival, than health care. The callous proposal in the budget to reduce inpatient episodes of care by 57,354 and outpatient episodes of care by a staggering 1,114,000 is beyond comprehension. Such a proposal highlights a total disregard for the Nation's commitment to veterans.

The reductions in the number of inpatient and outpatient episodes is to be achieved by treating fewer "low priority veterans." The budget fails to define or identify who these veterans are and it assumes that the denial of care to these veterans will not be offset by the demand for care currently being denied some 30,000 plus veterans each month. This effort is clearly an attempt to constrict the VA health-care system and allow dollars, not need, to shape the scope and operations of VA medical care.

The VA requested $10.041 billion to provide veterans VA medical care. Despite this request, the Administration and OMB allowed only $9.083 billion for this important veteran benefit, and in so doing failed to provide monies for the thousands of veterans who are being turned away from VA health-care facilities each month. They failed to provide for the expansion of the GRECC's (Geriatric Research Education and Clinical Centers) as mandated by Public Law 99-166, and they apparently shifted responsibility for dealing with the aging veteran population onto the states in that medical care provided in non-VA facilities is the only subaggregate of the medical care account that would receive any new monies.

The budget proposal notes that the funding levels requested will provide for the maintenance and operation of all existing VA health-care facilities. While physical structures may remain, services certainly will be diminished. The budget proposal which calls for the loss of over 7,500 FTEE's in medical care, including 1303 nurses and 475 physicians, assumes only a reduction in quantity of services provided. PVA contends that quality will also be reduced with the elimination of such a significant number of FTEE's involved in direct medical care.

Without these medical care personnel the VA is going to be very hard pressed to address the specific and emerging special program areas of: services to aging veterans; female veterans; Vietnam veterans; veterans exposed to Agent Orange and Ionizing Radiation; former Prisoners of War; and of particular concern to us, certain VAMC's may not be able to provide the highly specialized care and rehabilitative service to those veterans who are paralyzed due to spinal cord injury or disease. We have testified on numerous occasions that the VA system of 20 medical centers that specialize in spinal cord injury are unparalleled in this nation for their combined expertise and concern. It is incumbent to maintain the VA medical care account at a funding level that most adequately serves the needs of *all* veterans, both now and in the future.

In regards to the number of veterans eligible for VA health-care services, the VA estimates that under existing legislation, 11,984,000 could, if they so desired, qualify for care. Of this population pool, only about three million veterans availed themselves of VA medical care in 1984. Last year the Administration proposed legislation to implement a "means test" for health care eligibility. That proposal was very inequitable but a more realistic "means test," disconcerting as the concept is, was finally ironed our and agreed to by the Committees on Veterans' Affairs, Mr. Chairman, only to be denied realization because of a reconciliation stalemate over Superfund.

Hopefully, Mr. Chairman, the earlier adopted version of a "means test" can be pulled from existing legislation and enacted in lieu of the administration's test. Our concern for implementation of an equitable "means test" stems from the VA's fiscal year 1987 projected budget savings of more than $350 million and 6,988 FTEE's that purportedly will be realized by treating fewer "low priority veterans." We not only challenge the legitimacy of this cost savings, we fail to believe that the integrity of the VA health-care system can be maintained with such cuts in personnel and changes in patient mix.

In addition, we challenge the VA's or OMB's assumption that another 1,939 FTEEs and $57,200,000 can be realized through increased productivity in the medical care account during fiscal year 1987. We do not mean to imply there are not operations which cannot be improved or FTEE's who cannot be more effectively utilized, far from it, but it is high time that this administration realize what an efficient health-care delivery system it has operating within the Veterans Administration. According to the figures contained within the House Budget Committee's anal-

ysis of the 1987 budget, VA hospital and medical care costs have only risen approximately 50 percent, while demand has increased since 1980. This indicates a cost-effective system compared to the private sector where the cost of a hospital room alone has increased by 63.2 percent and doctor fees have increased 46.3 percent over the same time frame, according to figures recently released by the Bureau of Labor Statistics.

VA MEDICAL AND PROSTHETIC RESEARCH

Another area of the VA budget with which we are very much concerned lies in the area of medical and prosthetic research. The $226,634,000 that was expended in fiscal year 1985 for this vital investment in the future care and rehabilitation of severely disabled veterans represents less than 1/10th of one percent of the total VA budget; yet, this account took a nearly 18 percent or a $40 million cut in fiscal year 1986 budget considerations. Now, 7 months into fiscal year 1986, the President proposes to restore the $7,885,000 lost to sequestration back into this account in the coming year, but the research will be performed by 285 fewer FTEE's than were available last October. We view this unstable fluctuation of both funding and staffing as a devastating approach to maintaining the integrity of the VA's highly sophisticated, highly client-oriented research programs. Granted, as has been the case over many, many years, when monetary funds become scarce, research activities, especially those that do not hold promise of an immediate return on investment, are curtailed or in some cases terminated. We are very concerned that the VA's research efforts into central nervous system disorders such as spinal cord injury, disease, and regeneration will be seriously disrupted. Such vacillation of commitment toward the one ray of hope and cure for the insidious ramifications of the many, as yet, unexplained medical phenomenons, we view as being penny-wise and pound-foolish. The VA's list of "Who's Who" in medical and prosthetic research is extensive as well as impressive, and the benefits that are and can be realized by their combined expertise should not be taken lightly. We request that additional monies be channeled into this important portion of the VA's fiscal year 1987 budget, especially as it pertains to the VA's targeted high priority research which includes spinal cord injury and tissue regeneration.

PERSONNEL

Another aspect of the proposed fiscal year 1987 budget that is of concern to PVA lies in the VA Central Office's approach to maintaining critical manpower needs. We must question the rationale for all the reorganization proposals that have been submitted. We feel, this year, more so than in years past that the Veterans Administration has given up in their fight to advocate for the real needs of veterans and has instead decided that its new mission should be to maintain itself, meaning those bureaucratic functions that best serve that Administration, rather those that best serve the veteran population. This is harsh criticism to levy at the one agency within the Federal Government that is charged with the mandate of providing for veterans, and maybe after all the continuous assaults by this Administration to pare down the size of the federal government and shift more and more functions and responsibility to the state and local segments of our society, the VACO has assumed a "bunker mentality" and is engaged in a new mission of protecting its own employees at the cost of providing veteran services.

A prime example of this reprogramming of missions lies in its formation of the new Office of Facilities. When the budget proposes such drastic cuts in overall VA construction, it is difficult to understand why 733 FTEEs are needed to supervise a reduced function, whereas, without hard data to support the reduced need for hospital medical personnel, namely 1,303 nurses and 475 doctors, they choose to let these people go. We have been informed that certain of the nearly 7,500 FTEEs scheduled for termination in the medical care account are to be absorbed into this new office of facilities. This is good for those affected employees, but how will this reprogramming aid in service to veterans?

Another example of VACO entrenchment was their handling of the "sequestration order" that was recently issued by the President. In this situation the VA opted to reduce the amount of monies available for specially adapted housing, auto grants and adaptive equipment, all direct benefits to veterans, rather than lay off personnel within that line-item function that could result in a comparable cost saving. Again, the question must be asked—has the VA given up its role as chief advocate for veterans and is it now more concerned in trying to maintain the status quo among its own bureaucratic rank and file?

Another directive that has surfaced, not contained within the actual Fiscal Year 1987 VA budget per se, but contained in OMB documents relating to the VA's 1987 passback, was the mention made of restricting VA health care to nonservice-connected veterans to a maximum of 500,000 episodes in Fiscal Year 1987. The OMB directive to the VA indicated that it would approve funding for 1,243,700 inpatient episodes of veteran care, and limit nonservice-connected veterans to 500,000 episodes. PVA finds this directive not only unrealistic, but totally immoral, unprincipled and possibly in violation of congressional intent. The concept of establishing health-care usage ceilings might be an acceptable planning practice in the sterile, compassionless setting of the OMB office; but, when the VA's own data reveal demographic and patient profiles that support a totally different patient mix, then we are left to assume that OMB is in an outright assault on the VA's ability to perform its mission.

VA CONSTRUCTION

PVA believes the VA's fiscal year 1987 proposed construction budget of $408 million in new budget authority, a reduction of over $208 million from 1986, clearly demonstrates that the administration is continuing not to recognize (or to ignore) the importance of maintaining and building adequate facilities if the VA is to perform its assigned function.

Equally disturbing, or puzzling, is that while the VA's office of construction 1987 budget will be reduced by 34 percent from the previous year, and coupled with certain duties being taken over by another department, the construction employment level will increase by 49 FTEE's.

A newly constituted associate deputy administrator for management will now perform construction's independent facilities management and will be funded with 10 new FTEE's. In addition to all of this, an office of facilities, another brand new office created under reorganization, is requesting a funding level of $38.9 million and 733 FTEE's for 1987. It is hard to understand the Administration's or VA's rationale for the significant increase in FTEE's within construction and facilities management, when little or none is taking place.

The needs of the aging veteran population will continue to place an ever growing demand on the VA's health-care delivery system, escalating an already critical situation. It is a very serious matter that so many VA facilities are now in a state of decay, only marginally meeting the needs of the veterans who use them. In previous years, testimonies given by veterans' service organizations and the Department of Medicine and Surgery indicated that over half of all the beds located in VA facilities are in buildings 35 years old or older. Decaying facilities not only diminish efficient patient usage, they also hamper the recruitment and retention of qualified doctors and nurses.

The coming impact of the aging veteran had been a responsibility which the Veterans Administration was taking seriously. Now the VA has determined to shift its mission, by restructuring its long-term care policy, relying on the states and their communities to furnish the necessary facilities for providing care.

While the proposed fiscal year 1987 funding for grants for construction of state extended care facilities provides an increase of over 100 percent from the current year, the funding for the construction of VA nursing homes has been reduced by 82 percent.

The VA funding to assist the States in the acquisition or construction of State nursing homes or the remodeling, modification, or alteration of existing State veterans' homes has increased to $42.4 million in 1987, up over $21.6 million from the previous year level of $20.8 million. This drastic increase in funding is somewhat unrealistic when keeping in mind the necessary planning, and restrictions that states must adhere to, not to mention the necessary funding they must secure, before such a facility can be obtained or constructed. It is apparent that more and more of the solutions to problems are being shifted to the States from the Federal Government. This is just one more situation evident today where the Federal Government is relying on the states, which are already overtaxed and overburdened, to assist in solving a critical shortage in providing for our Nation's aging veterans. A task that is not rightfully theirs.

VETERANS' BENEFITS

Mr. Chairman, the area of readjustment benefits is an issue of concern to PVA as proposed in the fiscal year 1987 VA budget. The administration proposes to eliminate or significantly curtail numerous programs and services for veterans regardless of their obvious benefit and need. The new G.I. bill has already proven itself as a

viable educational asset for veterans. The exceptionally high participation rate has significantly been of value to the military and, more importantly, will have long lasting benefits for individual veterans and the nation as a whole.

The failure to provide funding for the "Emergency Veterans' Job Training Act of 1983" is equally disconcerting. While unemployment may have decreased for certain segments of society, for those veterans without jobs, the need for this program still exists. There remain thousands of unemployed, eligible veterans who have been certified for training under this program, but who have not entered actual training. To eliminate funding when the economy's recovery offers these veterans their greatest opportunity seems to be inappropriate and counterproductive.

Another issue of concern to PVA's members is the administration's attempt, within the proposed 1987 budget, to dismantle the VA's Home Loan Guaranty Program. Again, legislation is being considered this year, raising the current "users fee" from 1 to 2 percent, eventually rising to 3.8 percent by 1990.

The VA's Home Loan Guaranty Program is an entitlement program, with every veteran meeting the requirements being eligible for a guaranty of their mortgage up to 60 percent of the loan or $27,500, whichever is less.

PVA believes than an increase in the "user's fee", if enacted, would have a serious detrimental effect on the ability of veterans to obtain guaranteed loans, and thereby discourage veteran's home ownership. By raising the origination fee, veterans using their guaranty entitlement would either have to pay the increased fee up front, or have the fee added on to the loan.

This would result in a veteran needing a substantial amount of cash on hand, or having to add the users fee into the loan, thereby increasing the amount of the mortgage and inflating the property's actual value.

Equally disturbing within the VA's Home Loan Guaranty Program is the VA's plan to reduce the guarantee maximum by over $45,000 and to discontinue refinancing, both a result of Gramm-Rudman, all at a time when housing prices continue to rise.

Having already assisted over 11 million veterans in obtaining suitable, affordable housing, the VA Home Loan Guaranty Program has been, without a doubt, one of the more successful undertakings in this nation's history. This program has been a good investment in America, providing stability and expanding the tax base of nearly every community in our country.

Mr. Chairman, the fiscal year 1987 budget proposal does provide for a cost-of-living increase in compensation, dependency and indemnity compensation and pension. This is one positive aspect of an otherwise bleak budget proposal. These cost-of-living increases will ensure that veterans and their survivors will not see their quality of life eroded by the effects of inflation. However, these proposed increases are achieved through the reduction of other benefits and services provided by the Veterans Administration.

Finally, PVA would be remiss if we did not address the VA's recent approach to achieving savings mandated through sequestration. Effective March 1, 1986, there was a reduction in readjustment benefits paid to those veterans who are the more severely disabled, service-connected veterans. Vocational rehabilitation subsistence allowance, paid to those service-connected veterans who are in training, is cut over 13 percent. The grant for specially adapted housing, payable only to those veterans who are permanently and totally disabled is cut $2840. The grant to a service-connected veteran for the purchase of an automobile or other conveyance and/or to adapt one with necessary special equipment is cut $400.

This approach is abhorrent and reflects the insensitivity to and callous disregard for the service rendered by these eligible veterans. The VA demonstrated a willingness to reduce benefits for most seriously disabled service-connected veterans rather than explore other methods for achieving the same savings.

This recent effort and the fiscal year 1987 budget proposal seriously call into question the esteem and regard which this administration affords the Nation's veterans and their past service. Hopefully, this committee and the Congress will, as they have in the past, continue to honor and uphold the Nation's obligation.

Mr. Chairman, that concludes my statement. Thank you and the members of the committee for your thoughtful consideration of this issue, and I will answer any questions that I can.

PREPARED STATEMENT OF WALTER C. BOWIE, D.V.M., PH.D., DEAN, TUSKEGEE INSTITUTE SCHOOL OF VETERINARY MEDICINE AND PRESIDENT, ASSOCIATION OF MINORITY HEALTH PROFESSIONS SCHOOLS

Mr. Chairman, this is in response to your recent request asking for our response to the President's budget proposal for fiscal year 1987.

The Association of Minority Health Professions Schools (AMHPS) includes the Morehouse School of Medicine, Xavier University College of Pharmacy, Meharry Medical and Dental Colleges, Florida A&M University College of Pharmacy, Texas Southern University School of Pharmacy, Charles R. Drew Postgraduate Medical School, and the Tuskegee Institute School of Veterinary Medicine. We all rely heavily upon Federal institutional and student aid programs. The eight institutions of our Association have graduated 43 percent of the nation's black physicians and dentists, 50 percent of the nation's black pharmacists, and 90 percent of the nation's black veterinarians.

The President's budget proposal for fiscal year 1987 for the training of health professionals, Mr. Chairman, is again highly unrealistic, and although I hesitate to say so, is a real slap in the face to minorities in the Nation. The President's proposal to completely zero out support for health professions education is a clear demonstration of the callous views of the administration toward the goals of establishing a degree of parity among blacks and whites in the health professions. Further, the President's budget proposal is also an indication of the administration's confusion and misunderstanding of the real health and education disparities in the nation. Currently, in this Nation there is a significant gap in health status among blacks and whites in the Nation. Black infants are twice as likely to die in their first year as are white infants. Life expectancy for blacks is significantly lower than that of whites.

The Department of Health and Human Services recently established an Office of Minority Health under the Assistant Secretary for Health office. The charge of this office is to recommend Federal policies which seek to reduce the significant health status disparity among blacks and whites, and to implement those recommendations made by the HHS Secretary's Task Force on Black and Minority Health. How can the administration recognize the severe problem of health status by establishing this office, while proposing a budget that completely wipes out all of the programs that provide resources to the institutions that train minority health professionals, or eliminates grants or loans to minority students who attend our institutions? It has been documented that the best means of closing the health status gap is access to health care for minorities. Black health professionals are more likely to locate their practices in areas that are more heavily populated by blacks and other low-income minorities, thus providing this access. The administration proposals run completely opposite of this reasoning. Realistically, the administration's poor answer to the significant health status gap is to open a small office of minority health and shut everything else down. Believe me, Mr. Chairman, this will not work.

Thank you for this opportunity to present the views of the Association of Minority Health Professions Schools. We appreciate your efforts in the past, now, and in the future to fairly administer Federal health policy.

PREPARED STATEMENT OF THE AMERICAN LUNG ASSOCIATION AND THE AMERICAN THORACIC SOCIETY

The American Lung Association and its medical section, the American Thoracic Society, appreciate this opportunity to comment on the President's proposed FY 87 budget and the effect this budget would have, if enacted, on the health programs and services supported by the federal government.

ALA will focus its concerns on those programs relative to the prevention and control of lung disease. These diseases constitute a devastating and growing health problem in the United States. Lung diseases range from the chronic and often fatal diseases of the newborn, to serious infectious diseases, to those related to environmental exposures—workplace and ambient air, and to diseases attributable to cigarette smoking, the leading cause of preventable death. Including lung cancer and emphysema, lung diseases altogether rank third among the leading causes of death and sixth among the conditions responsible for premature retirement due to disability COPD—Chronic Obstructive Pulmonary Disease—is the most rapidly increasing of the 10 leading causes of death. The direct and indirect costs of lung diseases will be a staggering $36.5 billion in 1985.

Grim as this statistical picture appears, it is not hopeless. Federal programs of disease prevention, health promotion, biomedical research, environmental and occupational health hazard control, and professional education and training have greatly improved the detection and treatment of many of these diseases. Furthermore, there are many exciting advances at the threshold of being translated into new diagnostic and treatment modalities.

Our comments, Mr. Chairman, will primarily explore the impact of the President's proposed budget on the federal biomedical research program within the National Institutes of Health. Additional comments will focus on the Environmental Protection Agency's Air Program and conclude with the impact of the proposal to eliminate once again the program for Tuberculosis Project Grants administered by the Centers for Disease Control.

THE NATIONAL INSTITUTES OF HEALTH

The National Institutes of Health represent the largest source of funding for lung related research in the United States. This research program—principally within the National Heart, Lung and Blood Institute—has contributed significantly to the remarkable progress made in the past decade towards unmasking the basic physiological events underlying the development of lung diseases, and devising treatments and preventive strategies for these diseases. Such progress translates into great savings in the cost of caring for patients disabled from lung disease and in the cost of the loss of their productivity.

The largest program in lung related research is conducted within the NHLBI's Division of Lung Diseases. Other major research programs on lung cancer, allergic and immunologic diseases, and environmental related lung diseases are conducted by the National Cancer Institute, the National Institute for Allergy and Infectious Diseases, and the National Institute for Environmental Health Sciences. Below is a summary of the major sources of NIH supported lung research developed by the Interagency Technical Committee, Working Group on Lung Disease (data is provisional for fiscal year 1985):

NIH SUPPORTED LUNG RESEARCH

Institute	Fiscal year 85 (thousands)	Percent of support	Number of lung projects
NHLBI	128.15	57.3	716
NCI	29.48	13.2	164
NIAID	13.35	6.0	88
NIEHS	11.71	5.2	66

The President's fiscal year 1987 budget calls for a funding level of $4,936,157 for the NIH. This represents an approximate 8% reduction from the fiscal year 1986 appropriated level or a 4 percent reduction if the sequestration order is implemented as mandated by the Gramm/Rudman Act. This level of reduction will significantly impact the ability of the nation's research programs to address many public health and disease related problems. Using the fiscal year 1986 appropriated levels, the level of reduction for lung related research is even more devastating when reviewed in the aggregate. Below are percentage reductions for those Institutes supporting the majority of lung related research:

REDUCTIONS IN FEDERAL SUPPORT FOR LUNG RESEARCH

Institute	Fiscal year 1986 (thousand)	Fiscal year 1986 (G/R) (percent)	Fiscal year 1987 (percent)
NHLBI	859.2	−4.5	−8.6
NCI	1252.7	−3.5	−7.6
NIAID	383.4	−10.0	−13.8
NIEHS	197.5	6.0	−4.9

Because the NHLBI and its Division of Lung Diseases is the primary source of federal funds, our comments will focus on a review of the impact of the President's proposed budget on this Institute.

NHLBI: IMPACT OF THE PRESIDENT'S BUDGET

The largest portion of the NHLBI's research portfolio is the Research Project Grants. Only modest changes have occurred in this function; a reduction from the fiscal year 1986 appropriated level of 2704 competing and noncompeting grants to 2605 competing and noncompeting grants represents a 4 percent reduction. This limited reduction in numbers of grants is in part due to the specific language in the fiscal year 1986 appropriations bill requiring that NIH support 6100 new and competing grants. However, the funding levels have been reduced by 7 percent which will require that noncompeting research project grants be negotiated downward an average of 11.3 percent.

Reduction in the funding level of individual grants will have significant impact on the ability of individual researchers to accomplish the goals set out in their research grant. To begin with, the peer review process is extremely vigorous in cutting research grant budgets in the review process. A further 11.3 percent reduction will impair the scientific integrity of grants and in some cases, may make grants impossible to complete. A final comment regarding this reduction in the support of individual grants relates to the continued increase in the cost of certain types of research. Research which uses radioactive isotopes, for example, has become increasingly expensive as new methods are used to safely dispose of the waste.

Of significant concern to the ALA/ATS in reviewing the President's proposed budget reductions is that portion of the NHLBI's research program which supports Specialized Centers of Research—SCORs. Of the 60 Centers provided for in the budget, 24 are scheduled for competitive renewal in fiscal year 1987. Of this number, 16 are within the Division of Lung Diseases program. While the number of Centers to be funded has remained stable, the funding level is reduced by 13 percent from the fiscal year 1986 appropriated levels. Further confounding this budgetary dilemma is the fact that Centers are awarded for a 5-year period. During the renewal process significant budget growth is anticipated to counter previous inflation and allow for adequate resources throughout the period of the award. The President's budget allows $75,757,000 for this function. In reality $93 million should be provided, as a minimum, to allow adequate budget resources and enable the Centers to achieve their research objectives.

The SCOR program is a unique research mechanism which includes both basic and clinical research emphasis to ensure that advances in the basic sciences are quickly translated into applications at the clinical level. This research mechanism directly benefits patient and public health. A major reduction of this research mechanism will result in the slow-down of direct application of research findings and subsequent benefits to patients. Attached is a fact sheet on the NHLBI SCOR program in lung disease. A more detailed report is also available, should you wish to review it.

Lastly, a research function of interest to the ALA/ATS is that of research contracts. The President's budget shows a 3 percent reduction in funding from the fiscal year 1986 appropriated levels. This apparently modest reduction is misleading when the types of research supported by this function are considered. Research contracts support clinical trials, a research activity which studies and evaluates relevant clinical problems.

Within the Division of Lung Diseases, a major clinical trial was just initiated to study Chronic Obstructive Pulmonary Disease—COPD, the most rapidly increasing of the 10 leading causes of death in the United States. This clinical trial represents an eight year obligation by the NHLBI to determine if those persons considered to be most susceptible to the development of COPD can avoid these problems if they stop smoking, and, when deemed necessary, use certain medications.

During the first year, moderate costs have been encountered as the clinical trial study design and research protocol were developed. During the second year, major budgetary growth is necessary to absorb the costs related to equipment acquisition and patient recruitment—critical start-up activities if the trial is to be completed successfully.

A level of funding at approximately $75 million would allow continuation of the current level of support. This amount, however, would still cause significant limitations to start-up activities.

ADDITIONAL CONCERNS

There will be further impact on the federal biomedical research program if the trend of drastic reductions in the NIH budget is not curtailed. As funding levels fail to keep pace with the total obligation for research activity, as an example, it is anticipated that specific Institutes will become very conservative in their approach to funding new initiatives, especially research activity with long term obligations as in the areas of clinical application and epidemiology. An example is the so called "Six Cities Study" funded by the NIEHS for the past 12 years. It is a longitudinal epidemiologic study which is looking at indoor/outdoor air pollution levels correlated to measures of pulmonary function in children. The data base generated by this study is substantial and has been widely cited in many of the supporting documents for environmental regulatory action. Such a research program obligation may not be considered for funding in the future if funding levels are not stabilized with an adequate margin of growth.

THE ENVIRONMENTAL PROTECTION AGENCY: AIR PROGRAM

The EPA is charged with implementing this nation's environmental statutes. Of particular interest to the ALA/ATS is the Agency's enforcement of the Clean Air Act and its limited research activity in support of this regulatory mandate.

The President's proposed budget for fiscal year 1987 reduces the Air Program by 7.9 percent from the fiscal year 1987 appropriated levels. This reduction leaves a budget insufficient to aggressively pursue EPA's stated highest priority: to implement a comprehensive national strategy to control toxic compounds in the air and maintain an adequate level of programming to achieve attainment of the National Ambient Air Quality Standards, the cornerstone of the Act.

Of particular concern to the ALA/ATS is the President's proposed reduction of the Research and Development Program in Air by 7.7 percent. Such a reduction in a program already beset with major problems would be ruinous. The strictures already placed on the Research and Development budget and current program management problems severely limit EPA's ability to successfully complete necessary research activities to support its regulatory mandate.

EPA's research program is not funded and managed in a manner similar to that of the NIH. EPA can obligate funds for only one year, thus limiting the type and volume of research to be initiated. Further, at any point in the fiscal year monies can be re-directed by decisionmakers from the Assistant Administrator for Research and Development through individual laboratory directors, to purposes other than originally set out in the adopted research program.

The severe budget reductions have also forced EPA to reassess its research priorities. This is very unfortunate. As an example, EPA is decreasing support on mobile source pollutants. Its rationale is that a sufficient data base exists to maintain its regulatory activities. This may be a very short sighted reassessment. Recent work in EPA's own laboratories on ozone health effects has identified a possible link between ozone and inflammatory processes in the lung leading to the hypothesis that acute exposures to ozone may contribute significantly to the development of chronic lung disease. There is no existing data base and no current funding is anticipated to begin any initial investigation.

CENTERS FOR DISEASE CONTROL: TUBERCULOSIS PROJECT GRANTS

The ALA has an interest in the many public health programs administered by the Centers for Disease Control. A specific focus for the purpose of reviewing the President's budget will be the program of Tuberculosis Project Grants, first authorized by Congress in 1982. This program provides cooperative agreements to state and local health departments in high incidence areas for TB control activities.

Originally organized to combat this dreaded disease, ALA continues its commitment to the eradication of TB. ALA is again surprised by the short sighted action of the Administration to eliminate funding for this program.

In 1980, 28,000 newly diagnosed cases of TB were reported in the United States representing a 0.6 percent increase over that reported in 1979. Such an increase has only been seen twice in the last 25 years. A major contributing factor was the large number of cases diagnosed in the Indochinese refugee population. In 1981, the rate declined 6 percent to 27,373 cases and in 1982 a further decline of 7 percent was noted. This decline continued in 1983 and 1984 with 6.7 percent and 7.8 percent decreases respectively; decreases, noted by ALA, anticipated with an adequately functioning TB control program.

In 1985 it appears that once again there will be no decline in TB morbidity. Provisional data indicates that, if seen, the decline will be as little as 2 percent. Speculation is that once the data is finalized, this very small decline will disappear. In addition to the problems of drug resistant TB, TB among immigrants and refugees, and TB in children, new problems have emerged related to an increasing incidence of infection in those with the AIDS virus, and outbreaks among the homeless.

The program of TB Project Grants should be intensified in light of the current and emerging transmission problems rather than eliminated as the President proposes. Moreover, the program has undoubtedly saved third party payers millions of dollars in hospitalization costs. For example, Connecticut, Los Angeles and Massachusetts report annual savings of $81,000, $500,000, and $250,000 respectively through the use of outreach workers and directly observed therapy. Additionally, there has been much more widespread use of modern short-course chemotherapy regimens since the initiation of the TB Project Grants.

Transmission of TB in the United States should have ended years ago. The ALA recommends that the authorized level of $10 million be provided for TB Project Grants for fiscal year 1987.

CONCLUSION

As is clear from our comments, the federal government provides a significant source of funding to a wide range of programs directly impacting the prevention and control of lung disease. In the absence of adequate federal support, neither state nor local governments, nor the private sector are financially capable of continuing this level of programming. Furthermore, while it may appear tempting to assume that the private sector could be encouraged to accept some responsibility for support, this support might come at the high price of limited investigation or reversal of research direction. Consider what might be the knowledge base regarding the health effects of cigarette smoking, as an example, if the research effort has been directed by the tobacco industry.

Reductions to the extent proposed by the President will lead to the dismantling of the federal research program. This reduction would occur at a time when international industries are developing around our new biomedical technologies, negatively impacting on this economic growth. Great advances made over the last twenty years are now being capitalized upon in cell biology, molecular biology, and other biosciences. This past effort has clearly placed the United States in the forefront internationally and the level of effort must continue if our federal research program and the supporting industries are to remain competitive.

The health and biomedical research programs of the federal government give strength and leadership to our entire health care system. Adequate resources should be provided for continuing these programs at a level of priority indicated by the magnitude of lung diseases in the United States. Attached is a fact sheet summarizing the ALA/ATS appropriations recommendations for fiscal year 1987.

We are now at the threshold of remarkable breakthroughs in biomedical research which will lead to significant improvement in the health of the nation. We have a sound basis for environmental protection. The tools to eliminate what was once this nation's leading cause of death—TB, are available. Thus, now more than ever, vigorous support and adequate resources are essential.

AMERICAN POSTAL WORKERS UNION, AFL-CIO,
Washington, DC, March 11, 1986.

Hon. WILLIAM GRAY, III, M.C.,
Chairman, Budget Committee, Washington, DC.

DEAR CHAIRMAN GRAY: On behalf of the 330,000 members of the American Postal Workers Union and President Moe Biller, I want to express our appreciation for your continuing and sincere interest in protecting the hard-earned benefits attained through legislative action by our Union and the Congress over the many years.

We recognize your problems in this regard as Chairman of the House Budget Committee and being confronted by the Gramm-Rudman-Hollings law with President Reagan's proposed Fiscal Year 1987 Budget and related massive "take-aways" from postal and federal employees and our retirees.

We have been unable to testify before your Budget Committee concerning what I am confident will eventually be a considerably more equitable, fair and responsible budget to present to the U.S. House of Representatives.

In this regard, I testified on February 24, 1986 before the House Post Office and Civil Service Subcommittee on Compensation and Employee Benefits and Chairper-

son Mary Rose Oakar in support of her bill H.R. 4060 and in opposition to the President's FY '87 Budget slashes.

However, since our statement to Chairperson Oakar's Committee addresses the Fiscal Year 1987 Budget proposals of the President and also the related H.R. 4060 retiree COLA legislation, I have modified our February 24 legislative statement to be more consistent with your budget considerations and we will appreciate having the enclosed statement included in the Committee's printed hearing record. If you or your staff have any questions in this regard please call me at my office on 842-4210.

Also, the membership of our Union is greatly concerned and opposed to Section 1122(c)(1) of H.R. 3838, the so-called top reform measure approved by the House of Representatives in mid-December. This Section would repeal the present "Three-Year Exclusionary Rule" which provides initial income tax credits for postal, federal and other workers including Members of Congress and staff retiring after July 1, 1986.

We are unequivocally opposed to this proposed change in law and I am also enclosing President Moe Biller's statement and transmittal letter of February 7, 1986 to Chairman Robert Packwood and the Senate Finance Committee in this regard and for your information.

Sincerely

PATRICK J. NILAN,
National Legislative Director.

PREPARED STATEMENT OF PATRICK J. NILAN, LEGISLATIVE DIRECTOR, AMERICAN POSTAL WORKERS UNION, AFL-CIO

Mister Chairman, thank you for scheduling this hearing and permitting the American Postal Workers Union to submit a statement expressing our views on President Reagan's fiscal year 1987 Budget and also HR 4060 which would provide a full COLA in fiscal year 1987 for postal and federal annuitants.

My name is Patrick J. Nilan and I am the Legislative Director of the American Postal Workers Union, the largest postal union in the world with over 330,000 active and retired members who will all be affected by different aspects of President Reagan's budget proposals.

Once again we are here at the time, as we have done each year since 1981 to oppose the President's ill-advised and poorly conceived proposals to decimate postal and federal workers, their families and our nation's dedicated Civil Service annuitants.

We have appreciated the protection which you and your Committee provided postal and federal employees and retirees in the fiscal year 1986 House Budget Resolution and the related Reconciliation measure.

The evidence is clear that we are the targets—the scapegoats if you will of the right-wing advocates holding rein in this city. Our nation's current deficit of $220 billion for fiscal year 1986 was not caused by postal workers, yet we are being asked to have an unfair burden placed upon our shoulders to solve the problem.

Clearly our nation's massive increase in defense spending, with a corresponding reduction in taxes for the wealthy in The 1981 Tax Bill, has caused this massive deficit. As Majority Leader Jim Wright (D-TX) so ably has stated, President Reagan is The "Babe Ruth" of deficits, with a higher budget deficit than all of our nation's preceeding President's combined from George Washington to Jimmy Carter regardless of being Democrats or Republicans.

When President Reagan submitted his fiscal year 1987 Budget to Congress this year requesting a larger increase in defense spending 6–8 percent beyond inflation, and he coupled that with a request that he would not consider any changes to Social Security nor any additional revenues, he has positioned himself to reject any reasonable compromise the Congress might offer.

The passage of the disastrous Gramm-Rudman-Hollings balanced budget amendment as a part of the increase to $2 trillion in the debt ceiling measure on December 11, 1985 by the Congress, which was signed on December 12, 1985 by President Reagan, has caused great consternation in Washington and throughout America. The requirement to have a balanced budget by 1991, with sequestration or automatic triggering mechanisms places an unfair burden upon the American public and is unevenly split among all Americans.

America's tax dollar goes to the following areas: 28 cents to defense, 20 cents to Social Security, 14 cents for interest on the debt and the remaining 38 cents on all domestic programs. Under the provisions of Gramm-Rudman, contested in court and

pending a Supreme Court decision, a triggering mechanism called sequestration, will occur if Congress cannot agree on a budget. The American Postal Workers Union has filed suit in this case because we don't believe that Congress can delegate away its Constitutional authority to make the hard decisions about spending and because the separation of powers clause clearly defines the responsibilities of the Executive Branch, Legislative Branch and Judicial Branch.

Let's examine President Reagan's FY87 budget proposals:

Increase in postal worker contribution from 7 percent to 9 percent for the Civil Service Retirement System. This amounts to nothing more than a 2 percent pay cut for postal workers. Postal workers already pay 8.45 percent toward retirement which includes the Medicare tax of 1.45 percent. President Reagan has stated he will not raise taxes, yet this proposal would do exactly that.

What would the adverse impact be on postal workers? The following chart clearly shows the effect:

[In dollars]

Annual Salary	Loss in take home pay if retirement deduction is increased	
	Per year	Over 30-year career[1]
$20,000	$400	$26,575
22,500	450	29,897
25,000	500	33,219

[1]Assumes a 5 percent wage increase per year.

This proposal would raise $900 million in fiscal year 1987, and $1.2 billion in fiscal year 1988 and fiscal year 1989 according to the President's budget.

APWU feels this proposal by the Administration is way out of line with programs provided to other employees not employed by the Federal Government. In the private sector many employees are covered by Social Security and noncontributory pension plans. These employees contribute 5.7 percent of wages, up to a ceiling of $42,000 in 1986, into the Social Security retirement, survivors and disability fund (OASDI). Many times the total amount of contributions to retirement is the 5.7 percent.

Postal workers, along with federal employees, contribute toward the Civil Service Retirement System. The entire income is subjected to a CSRS contribution of 7 percent. This is a difference of 1.3 percent more than Social Security, and this gap would widen this October to 3.3 percent if the President's proposal is adopted.

We respectfully request this committee to reject this proposal as they have done during previous budget debates.

Pre-Age 62 retirement penalty: The Administration has proposed to penalize postal workers who desire to retire between the ages of 55 and 62. The proposed pre-age 62 retirement penalty would be a 2 percent reduction of an annuity per year, or a maximum 14 percent reduction in an earned annuity of retiring at age 55.

Again the Reagan Administration, despite a State of the Union speech glorifying the American family, seeks to place an additional burden on the postal or federal employees family. In essence they want employees to work longer (raising the retirement age), contribute more (raising the contribution rate), and receive less (freezing and permanent reductions of COLA) in retirement. Instead of being a pro-family budget, these proposals are definitely anti-postal and federal worker family budget.

Mr. Chairman, postal workers entered the Postal Service with certain commitments from their employer, with respect to retirement and health benefits in exchange for a lifetime of service. The employees have not reneged on their end of the bargain—but the President, as the Chief Executive of this nation—has continued his relentless campaign to undermine our career employees.

I travel extensively around the country visiting with union leaders and rank and file postal workers. Their biggest fear is having what is rightfully theirs—the terms and conditions of their employment and financial security—being dismantled by the President and the Congress under the guise of "fiscal responsibility".

A postal worker aged 51 with 30 years of service, would be expected to work until age 62 to collect full benefits or lose 14 percent of his/her annuity if retiring at age 55.

Let's look at the impact for some typical APWU members. A typical APWU member at 55 with 30 years of service who elects to retire can anticipate a yearly annuity of $13,000, which is not a large sum by today's standards for a lifetime of dedicated service.

If President Reagan's proposal to slash benefits for early retirement were enacted this year, it would be phased in by 1990. The size of the loss would depend on the employee's current age and then the age at retirement. (The figures assume that the employee is in Level 5/Step 12 and retires with 30 years of service).

Annual benefits lost under Reagan proposal if retirement occurs at: Members current age: age 55, $1,820; age 58, $1,640; age 60, $520.

This benefit loss does not include the value of cost-of-living adjustments, which would increase the loss if COLA's were to be paid on a timely basis based on the full CPI.

NO COLA IN FISCAL YEAR 1987

President Reagan proposes to freeze fiscal year 1987 COLA for postal and federal annuitants. The fiscal year 1986 COLA of 3.1 percent was scheduled to be paid effective with the January 1986 checks and last year Congress approved such payments. However, because of the passage of Gramm-Rudman in December 1985, the January 1986 COLA adjustment was suspended. Postal and federal COLA's, as well as FECA, are considered in a non-protected status under terms of Gramm-Rudman.

Madam Chair, we appreciate greatly your efforts in introducing HR 4060, to restore a full CPI COLA for postal and federal annuitants effective in 1987. The American Postal Workers Union is committed to working with you, your Committee and staff, to ensure its early enactment into law.

For us this question is one of equity. Fairness dictates that all retirees be treated alike.

Social Security and Veterans Disability COLA's were paid this January, as approved by Congress, since both worthy programs are in a protected status. But Civil Service Retirement COLAs as previously mentioned were not paid, nor retired military, railroad pensions, FECA, COLA's, nor Black Lung COLA's. What separates one retiree from another? Certainly not prices for goods and services in stores and in the society at large. Prices are uniform for all consumers. For that reason, COLA's should also be uniform for annuitants.

Mr. Chairman, in this regard, we urge you and the committee to restore the January 1, 1986 COLA to these retires who were discriminated against by being treated unfairly and inequitably!

Every single year the President's budget attacks our annuitants. Perhaps if President Reagan had a personal budget to meet in terms of an annual $13,000 annuity as our members have, then maybe he would be more interested that they should live with a certain element of dignity, which they are being deprived, as they live each year with less spendable income, as a result of COLA delays, freezes etc

Let's review some of the recent CSRS COLA changes which include:

1. Repeal of the 1 percent COLA add on starting in 1977.
2. Change from semi-annual to annual COLA adjustments in 1982.
3. One-half COLA for retirees under age 62 in 1983 and 1984.
4. Delaying all COLAs one month in 1983.
5. Permanent delay of COLA for 8 months beginning in 1984.
6. Suspension of the fiscal year 86 3.1 percent COLA adjustment scheduled to be paid in January 1986 because of sequestration due to Gramm-Rudman.

Under the fiscal year 1987 budget proposal the President wants to freeze CSRS COLA's in 1987 and because of the threat of Gramm-Rudman, we may see no retiree COLA's for five years! No other element of American society is being asked to burden such sacrifices.

President Reagan also has asked Congress to permanently change the law so CSRS COLAs would be paid on a CPI (Consumer Price Index) minus two percent. The net effect of this change is to steadily drive down further the standard of living for our annuitants because as they live longer, the less their replacement rates to their final income will become. I don't want to believe that the Congress or the American people want to see their senior citizens who are Government retirees driven toward the poverty level.

High 3 to high 5 retirement computation base. The current budget which this committee is studying again contains a recommendation to change the annuity cal-

culation base from the highest three years of service to the highest five years of service. This would not affect employees within three years of retirement eligibility.

APWU stands firmly against this proposal which would wipe out the progressive 1969 law which established a "High 3" annuity calculation base. This proposal reduces the salary base and results therefore in a lower annuity.

When this issue was debated last year before the Congress APWU took an example of a "typical" postal employee retiring at age 61 and receiving an annual benefit of $15,000. We assumed a 3 percent salary increase in the last 5 years of his/her career and calculated that our annuitant would, (if the law were changed), have a benefit loss of $428 per year. Obviously as COLA adjustments to the basic annuity were received over the course of a lifetime of retirement, the $428 loss would continue to grow.

Federal employees health benefits proposals. One proposal contained in the FY87 budget is to eliminate the "big six" average of government health plans to determine the government share, and institute a program-wide average, to be increased annually by the implicit price deflator of GNP.

Again this proposal is intended to "save" the Government money, and to pass the additional costs on to the employee and retiree. However, with over 100 plans in the FEHBP, one can see that there would be a considerable savings, since not all even provide "High Option" coverage. But the employee and retiree who would be hurt, by paying a higher premium, coupled with deductibles and co-insurance, previously pushed by this Administration, are those who need to utilize their health plans the most. Those are our postal and federal employee senior citizens who naturally need more medical care as they advance in years, as do all Americans.

Despite the President's statement that some Federal programs such as Civil Service health benefits "have become overextended, misdirected, or operate on too expensive a scale", FEHBP is the Government's commitment to its employees and annuitants. President Reagan's thrust that his budget "preserve benefits for those in need" is very hollow in terms of the reality of his proposals and patently unfair and discriminatory.

Dropping the 75 percent ceiling on FEHBP government contributions. Also in this budget we find a request to eliminate the 75 percent ceiling on Federal Employee Health Benefits plans and to substitute a fixed government contribution, which is generally known as a voucher. The stated goals are to "increase competition", and "encourage employees to select low-cost plans."

APWU opposes this plan since medical costs have continued to escalate, even above general inflation. For example in 1984 inflation rose 4.2 percent, but medical costs soared 6.1 percent. This loss was nearly 2 percent in 1984 if this were law that year. In future years, the Government contribution, under this proposal, would reduce further and further, if medical costs continued to increase at rates faster than inflation. Postal and federal employees, retirees and their families would experience less benefits at higher personal cost.

Elimination of the 75 percent cap on federal agency premium payments could provide a temporary windfall to federal employees who select low option plans, but over time it would mean lower federal agency contributions and FEHBP enrollees with higher medical costs would be required to pay greater out of pocket costs.

Comparisons to health benefits in the private sector. The Administrations' proposals to reduce the value of the FEHB program fly in the face of numerous studies which show that FEHB falls considerably short of what the private sector offers in benefits and pays towards the total premium. Three studies are available to Members of Congress: GAO (HRD-83-21); Mercer Report for the House Post Office and Civil Service Committee (Committee Print 97-8), and the Hay/Huggins report also issued for the P.O. and C.S. Committee (Committee Print 98-16).

The Mercer report showed that the average FEHB plan plus the federal premium contribution was 21 percent less than the average large plan provided to employees in the private sector. The Hay/Huggins report showed that FEHB provides health coverage which is lower in value by 2.2 percent of the total payroll cost when compared to health plans offered to private sector employees.

Elimination of revenue foregone subsidies. The Presidents fiscal year 1987 budget requested elimination of the U.S. Postal Service Revenue Foregone Subsidies, and proposed legislation to enable the Postal Service itself to continue the subsidy for most existing mailers.

The current fiscal year 1986 Budget contains $749 million for Revenue Foregone subsidies. The Revenue Foregone subsidy through the appropriation process has been used to offset the loss in postal revenues for providing reduced-rate mailing for certain groups such as the blind, the handicapped, rural newspapers, classroom publications, and charitable organizations.

The APWU believes that the Revenue Foregone subsidy should be continued and that revenues derived from general taxation through the appropriations process should be used to support national social policies such as reduced-rate mail.

Increased phase-in of USPS payment to CSRS. Another drastic change proposed in the FY1987 budget, which was previously rejected, would require the Postal Service to begin paying the actuarial cost of employee pensions to the Civil Service Retirement System.

The American Postal Workers Union believes that such a major change should only be considered in terms of the Supplemental Retirement program currently being debated in the House-Senate conference on HR 2672.

However, our policy was stated last year in response to a question from this Subcommittee, and is being re-submitted for the record. "The APWU believes that the Postal Service share for retirement benefits should not be any greater than the federal share per retiree for federal employees. The President's proposal would essentially mean that pensions for postal employees would be fully funded in advance, a condition not required of federal workers and their agencies. Assets would accumulate in the trust fund but would be available in support of all retirees, since assets are not segregated by agency of employment. This means that even though postal and federal workers get the same retirement, The Postal Service would have to pay more than other agencies."

In summary, Mr. Chairman, I would like to again thank you for your past support, and reaffirm our opposition to the Presidents fiscal year 1987 budget proposals under consideration here today. We support fully HR 4060, your bill to require a full CPI COLA for federal annuitants in 1987; and with the amendment we have proposed to restore the January 1, 1986 retirees COLA will work with you for its enactment into law.

Finally, we wish to submit for the record the General Accounting Office Survey completed last year for the Post Office and Civil Service Committee which shows that the changes in law from 1974–1984 resulted in a nearly $40 billion reduction in postal and federal workers pay, retirement and health benefits. Obviously we've contributed more than fair share to resolving budget deficits, and if the GAO Study was updated the $40 billion figure would be much higher. Now it's Congress' turn to look at budget reduction, but frankly enough is enough!

Thank you Mr. Chairman for this opportunity to present these views on behalf of the American Postal Workers Union and our 330,000 postal worker and retiree members.

UPDATE BY THE HOUSE COMMITTEE ON POST OFFICE AND CIVIL SERVICE
OF AN EARLIER REPORT PREPARED BY THE GENERAL ACCOUNTING OFFICE

SELECTED CHANGES IN PAY AND BENEFITS AFFECTING FEDERAL EMPLOYEES

FISCAL YEARS 1975 TO 1985

Significant changes	Estimated Effects of Changes (note a)											
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	TOTAL
	(millions)											
Reductions in scheduled pay increases for white-collar federal employees	$ -0-	$804.1	$ -0-	$ -0-	$ 808.4	$ 985.8	$1288.7	$3186.8	$4827.8	$ 6368.3	$ 5519.7	$24048.4
Delays in scheduled pay increases for white-collar federal employees										315.2	329.3	104.5
								380.0[b]	380.0[b]	703.0[b]	980.0[b]	2443.0
Revisions in the Federal Employees Health Benefits Program									600.0	800.0	900.0	2300.0
Implementation of social security hospital insurance taxes (medicare) to be paid by federal employees							22.0	22.0	22.0	25.0	26.0	117.0
Elimination of paid holidays from lump sum annual leave payments upon separation from federal service										130.0	131.0	261.0
Revision in the basis for computing general schedule pay from 2,080 hours to 2,087 hours												
Retirement System Legislation:												
- Public Law 94-440, 10/1/76, changes in cost-of-living adjustments and 1 percent add on[c]			125.0	208.0	337.0	492.0	540.0	550.0[b]	550.0[b]	550.0[b]	550.0[b]	3902.0

• Public Law 96-499, 12/5/80, "Omnibus Reconciliation Act of 1980												
Modification of minimum benefit provisions for disability retirement							49.0	49.0	49.0	49.0	49.0	245.0
Repeal of the lookback annuity guarantee provision							270.0	270.0	270.0	270.0	270.0	1350.0
								430.0	430.0	430.0	430.0	1720.0
• Public Law 97-35, 8/13/81, Omnibus Budget Reconciliation Act of 1981[8]									180.0	203.0	203.0	586.0
• Public Law 97-253, 9/8/82, Omnibus Budget Reconciliation Act of 1982[9]										362.0	1116.0	1478.0
• Public Law 98-270, 4/18/84, Omnibus Budget Reconciliation Act of 1983[10]												
Eligibility requirements for disability retirement						140.0	140.0	140.0	140.0	140.0	140.0	840.0
Total	1 -0-	$804.1	$125.0	$208.0	$1143.4	$1617.6	$2309.7	$3027.8	$3449.8	$3607.5	$3703.5	$13996.9

(nearly $40 billion)

[8]Based on Office of Personnel Management, Congressional Budget Office, and Office of Management and Budget data.

[9]These figures were estimated by the Office of Personnel Management and include the reduction in benefits and increased premium costs for participants.

[10]Public Law 98-440 eliminated the additional 1-percent annuity adjustment and provided a new process for semiannual adjustments, based on the actual percentage rise in the CPI.

[8]These estimates are based on pre-1983 data; estimates for 1982, 1983, 1984, and 1985 were not available.

[9]This law changed the annuity adjustments for federal retirees from semiannual to annual.

[10]This law limited cost-of-living adjustment increases to one-half the increase in the CPI for retirees under 62 years of age; it also made administrative and retirement eligibility changes.

[11]This law changed the annuity adjustment date from June 1 to December 1 of each year based on the percent change in the price index for the base quarter for such year over the price index for the base quarter of the preceding year.

AMERICAN POSTAL WORKERS UNION, AFL-CIO
Washington, DC, February 7, 1986.

Hon. BOB PACKWOOD,
Chairman, Committee on Finance, Washington, DC.

DEAR MR. CHAIRMAN: On December 26, 1985 and again on January 28, 1986, I wrote to you requesting that I be given an opportunity to testify before your Committee on Finance concerning tax reform and specifically the proposed repeal of the three-year exclusion rule and related income tax credits when postal and federal workers first retire. This adverse proposal by the House approved H.R. 3838, Section 1122 (c)(1) would have a devastating affect on our members at time of retirement.

Our Legislative Director Patrick J. Nilan advised me that the staff of your Committee has told him that our Union cannot be scheduled to testify and it appears your hearings have been completed. Assuming this information is correct, I can only say that we are very disappointed as I cannot recall any occasion in recent years when our Union has been denied the opportunity to testify before a Committee of the Congress on a legislative issue affecting our 325,000 members.

It is my hope that your Committee will schedule additional hearings and reconsider our request to testify. If not, I am enclosing our statement on tax reform and the proposed repeal of the "3-year rule" which I will appreciate having enclosed with this letter in the hearing record. If anything further should develop please contact our Legislative Director at our Washington, D.C. office, 842-4210.

Sincerely,

MOE BILLER
President.

Enclosure

PREPARED STATEMENT OF THE AMERICAN POSTAL WORKERS UNION, AFL-CIO, PRESENTED TO THE COMMITTEE ON FINANCE CONCERNING TAX REFORM, U.S. SENATE

This statement is being presented by the American Postal Workers Union, AFL-CIO on behalf of our 330,000 active and retired members to the Committee on Finance of the U.S. Senate concerning Tax Reform legislation which is being considered by the Committee. The officers and members of our Union appreciate this opportunity to present our views in this regard.

Of immediate and great concern to our membership is the proposed repeal of Section 72(d) of the Internal Revenue Code, the so-called "three-year exclusion rule," as provided in Section 1122(c) of H.R. 3838 and approved by the U.S. House of Representatives. Section 72(d) of the IRC presently allows employees who have contributed to their respective retirement trust funds up to a three-year post-retirement tax free period. Such employees previously paid required income taxes through payroll deductions during their pre-retirement working lives.

The controversial and adverse change proposed in the House-passed H.R. 3838 tax bill would be effective for employees retiring on and after July 1, 1986. If enacted into law, this negative proposal would be a financial disaster for approximately 19 million Americans, primarily postal, federal, state, county, municipal and private sector employees who contribute to their retirement plans.

Under current law these loyal and hardworking employees at retirement, as an annuitant are allowed a tax-free period of up to three years to recover through annuity payments an amount equal to the amount he or she contributed from their wages to the retirement system during active employment.

However, the bill passed by the House of Representatives would repeal this three-year rule and make tax-free only a small portion of each employee's contributions in any given year. The balance would be returned over any given year. The balance would be returned over an actuarially determined period (perhaps as long as 20 years), thus assuring that many retirees may never receive full tax-credit amounts they personally contributed into the system and paid taxes on during their working lives.

The net effect is that many employees who have planned for retirement under the current tax laws will not only face an immediate financial loss, but also face a disruption of other plans they may have made to provide for long-term financial security in their retirement years.

APWU has calculated that an average single postal retiree, receiving a $13,000 annuity, would pay an additional $940.90 per year in taxes for each of the first three years under the H.R. 3838 House legislation if the three-year exclusion rule is repealed. A joint-filing postal retiree would pay $360.00 per year for each of the three years under this controversial proposal.

It is important that we address the suggestion that some postal retirees could be better off over their entire retirement life under the House approved measure. The

philosophy being that by spreading the employee contribution exemption over (for example) a 12-year retirement period some retirees could benefit more from being in a lower tax bracket for all those years rather than taking the tax break up-front during the first three years.

In the case studies we were able to look at, we discovered that some retirees could pay less in actual dollars, but because of the time value of money, a "real" dollar today would be worth more than an inflated dollar next year and certainly over a 12-15-20 year period these retirees would be worse off over their full retired lifespan.

Repeal of the three-year rule also raises the obvious question of fairness. Postal and federal retirees will be particularly hard pressed to meet this new tax obligation, considering the reductions they have already had to endure. In the fiscal year 1986 Budget, the ax fell particularly heavy on federal and postal workers and retirees, and the Gramm-Rudman legislation appears ready to bury the hatchet even deeper into the backs of these mistreated employees and annuitants.

During the past 10 years, postal and federal workers and retirees have been required to suffer more than $40 billion in lost income from reductions and delays in scheduled pay increases . . . revisions in the Federal Employees Health Benefits Program . . . imposition of the Medicare hospital insurance tax . . . elimination of paid holidays from lumpsum annual leave payments upon separation from federal service . . . revisions in the basis for computing general pay from 2080 to 2087 hours annually . . . changing the annuity adjustments for federal retirees from semi-annual adjustments . . . limiting the COLA to one half of the increase in the CPI for retirees under 62 . . . denying any COLA to military retirees employed in the Civil Service . . . postponing the COLA . . . covering postal and federal employees hired after January 1, 1984 under Social Security . . . reducing the so-called "windfall" benefits created by dual entitlement to Civil Service retirement and Social Security . . . reducing Federal retiree's Social Security spouse's benefit by an amount equal to two-thirds of their government pension . . . and finally, the suspension of the January 1986 annuity COLA.

These cuts and their accumulated 40 billion dollar savings—calculated by the General Accounting Office and updated by the House Committee on Post Office and Civil Service—have also been accompanied by loss of jobs through reductions in force and contracting out.

Mr. Chairman, I believe evidence points out very clearly that the 330,000 active and retired members we represent have suffered more than their fair share. The House H.R. 3838 measure proposal to raise $7.5 billion by repealing the three-year rule is patently unjust and unfair! This large sum could only come from the "pockets" and annuities of retirees.

Another important reason to retain the "three-year exclusion rule" from the standpoint of efficient, cost-effective and essential Government services must be the great concern for a potential mass exodus of the Nation's most senior, qualified and sorely needed postal and federal workers from the lowest to the highest salary positions and who are eligible for immediate retirement prior to the effective date of the tax-reform measure. Such a tremendous personnel loss not only to the Federal government but also, potentially the Congress of the United States and staff persons would be an inexcusable and irretrievable loss to "good government" and the American people.

The American Postal Workers Union desires to express our appreciation and gratitude to your colleagues, Senators Paul S. Trible, Jr.; Ted Stevens; Charles McC. Mathias, Jr.; Thomas F. Eagleton; Ernest F. Hollings; and Paul S. Sarbanes for their joint sponsorship of Senate Resolution 304 which was referred to your Committee on January 29, 1986 and states:

"Resolved, That it is the sense of the Senate that section 1122(c)(1) of H.R. 3838 repealing section 72(d) of the Internal Revenue Code of 1954 pertaining to the 3-year basis recovery rule on taxation of retirement annuities will be deleted from the tax reform legislation now pending before the Senate Finance Committee, and that the present 3-year basic recovery rules will be maintained."

Mr. Chairman and Members of the Committee it is our hope that you will concur with the recommendations of your distinguished colleagues who have in an exemplary demonstration of bipartisanship and statesmanship urged rejection of Section 1122(c) of H.R. 3838. We urge you to review the entire text of the Senate Resolution 304 and their well documented explanation for introducing and supporting the resolution on January 29, 1986.

We believe repeal of the basic recovery rule will do irreparable harm to the government, its employees and retirees in a time when they have already suffered more than what any reasonable person would consider fair and equitable. We

strongly urge you and the other members of this Committee to delete this controversial proposal from your tax reform package.

Now, a few additional comments concerning the H.R. 3838 tax legislation pending before your Committee. The measure does contribute general equity and fairness to most taxpayers exclusive of the proposed repeal of the IRC Section 72(d).

The average ordinary taxpayer—who has been paying most of the Federal Government's bills while the rich and big corporations exploit special loopholes and avoid paying their fair share of taxes—would benefit from the bill. It appears more than half of the net tax reductions would go to those with incomes between $20,000 and $75,000. Most features of the current tax system which most benefit average Americans would be preserved by the legislation.

For example, the bill retains the deduction for state and local taxes—the most widely used of all deductions. In fact, a survey commissioned by the American Postal Workers Union last year found that over 59 percent of our members were entitled to a credit for state and local taxes.

The House Ways and Means Committee was correct in continuing the present treatment of state and local taxes instead of following the Administration's proposal to punish those areas that have done the most to finance public programs and facilities. Again, we recommend the Committee concur in this decision.

The American Postal Workers Union with others in the labor movement, campaigned long and hard to convince Members of the House of Representatives that the proposal to tax "life-support" benefits was poor tax policy and a backdoor attempt to raise taxes on the backs of the lower and middle-income Americans. We were successful and hope this Committee will not consider such ill-advised taxation further.

While the measure provides badly needed relief for most taxpayers, it also reaffirms the principle that everyone should pay their fair share of taxes! The bill's tough and comprehensive minimum tax would ensure that neither corporations nor wealthy individuals could completely avoid federal income taxes.

H.R. 3838 would put a stop to accounting practices which allow major defense contractors to avoid the taxes that pay for our national defense. Under the measure, foreign tax havens would be curbed, tax breaks for the oil and gas industry would be reduced, large banks would have to pay more than the token amounts required by current law, and limits would be placed on deductions for business meals and entertainment.

Thank you Mr. Chairman and Members of the Committee for giving us this opportunity to express these views concerning tax-reform on behalf of our 330,000 members and retirees. I will be happy to respond to any questions concerning our testimony and provide any related additional information requested.

Prepared Statement of the American Federation of Labor and Congress of Industrial Organizations

The AFL-CIO presents the following comments and recommendations regarding the Administration's 1987 budget proposal.

The Administration's budget proposal is a continuation of the unbalanced policies followed since the beginning of this Administration. The major elements of that program are deep spending cuts in domestic programs and a rapid growth in defense. Despite the continuing cost of the 1981 tax cut, the tax structure is ignored in the Administration's attempts to control deficits.

The threat by the President to veto any proposal to raise tax revenues and the large increases in defense spending will devastate many domestic programs. The Congress should refuse to increase defense spending at the expense of domestic programs. If Congress determines that some program reductions are necessary to impose budgetary restraints, defense spending must not be exempted from such cuts.

The President recognizes the government's responsibility to provide for defense, but has ignored the responsibility of government to promote the general welfare. Congress should not allow the Administration to abdicate its role to provide for the general welfare of all Americans, including workers, their children, their parents and the poor.

The AFL-CIO urges Congress to raise additional tax revenue, based on fair taxation as the only alternative to unacceptable budget cuts.

The fiscal year 1987 budget proposal includes cuts in funding for fiscal year 1986 programs. Although the funds for fiscal year 1986 programs have already been approved, these programs have been cut by the automatic features of the Gramm-

Rudman-Hollings Act which became effective March 1. However, the Administration's budget calls for further rollbacks, rescissions, and deferrals.

The approach of the Gramm-Rudman-Hollings Act for fiscal year the 1987 budget and future budgets is as dangerous and irresponsible as the Administration's budget. The across-the-board cuts it could require are no more acceptable and no less irresponsible than the cuts proposed by the Administration.

The AFL-CIO urges Congress to repeal the Gramm-Rudman-Hollings Act.

WHERE THE CUTS HIT HARDEST

Unemployment remains a serious problem among many skilled and experienced workers as well as among those who lack education and skills. Despite the magnitude of the problems, the Administration has proposed substantial cuts in the programs which provide aid and training for dislocated workers.

A major cause of hardship has been the massive trade deficit which has cost 3 million jobs in 1985. Despite the hardship caused by trade, the Administration's budget contains nothing for trade adjustment assistance to help workers who lose their jobs because of imports, and the program has been targeted for extinction.

The Administration calls for a cut in the program to train dislocated workers under Title III of the Job Training Partnership Act (JTPA) of 21 percent in 1986 and another 48 percent in 1987. Block grants provided to the states under JTPA for training and employment programs have been phased down since 1984 and would have no increases in 1987 even though the funds are so low that the program can help only 5 percent of those needing assistance.

In spite of the Job Corps' demonstrated success in providing remedial education and job skills training to disadvantaged youths, the Administration proposes to cut budget authority for the program from $612 million in 1986 to $352 million in 1987. The proposed drop in funds would reduce the number of youths who participate in the program from 100,000 down to 60,000.

The proposed cut in the budget for summer youth jobs would reduce the number of jobs for disadvantaged youths from 785,000 in 1985 to 414,000. This cut is proposed in spite of unemployment rates for black teenagers of over 40 percent.

The Administration would freeze the funding for the older American jobs program at the 1985 levels through 1988. This program provides part-time public service employment for older workers through service organizations and grants to the states. The program is in need of expansion to help cope with the dislocation of older workers.

The Administration has proposed to eliminate the Work Incentive Program (WIN) in each of its budgets since 1983. Each year, the Congress has refused to do so. In 1986, $9 million was cut to conform with the Gramm-Rudman-Hollings Act. The Administration wants no funding for 1987 and has proposed a $46 million rescission in 1986 to speed up the program's end. This program is valuable in its provision of employment services, training, and public service jobs to recipients of aid to families with dependent children.

Grants for the Employment Service made to the states provide job search and placement services to job seekers and recruitment services to employers. Money to pay for this program is funded separately through the unemployment insurance tax. The Administration proposes to freeze these grants at the 1986 level and is considering the termination of the federal role in this program. This would destroy the present federal/state system which dates from 1932.

The budget makes no provision to provide adequate unemployment compensation to the unemployed. Currently, only one-third of jobless workers receive unemployment benefits compared to three-fourths in 1975. These cuts in training and employment programs should be rejected by the Congress.

HEALTH

The Administration's proposed budget for 1987 would jeopardize the health security of the entire nation. Senior citizens, the poor, jobless workers, federal employees and veterans would all suffer cutbacks in services or be forced to pay more for treatment. Furthermore, the entire national medical research effort would suffer and quality of care for seriously ill patients would decline because of proposed cutbacks in funds for medical education and support for teaching hospitals.

The Administration proposes to reduce Medicare expenditures by refusing to pay hospitals the full amount of costs they incur in treating elderly and disabled Medicare beneficiaries. Such action will encourage in-patient facilities to reduce services to Medicare beneficiaries as well as discharging them prematurely and without adequate support systems for continuing health care needs. From all parts of the coun-

try. Medicare beneficiaries are reporting that they are being told that prior Reagan cutbacks have adversely affected the quality of their care. The current proposals will exacerbate this already serious situation.

The Administration proposes to cut Medicaid's expenditures $1 billion next year. In subsequent years, the Reagan budget would put a cap on the growth in this program which serves the poor, including women and children and jobless workers. This proposal follows recent national reports about record increases in infant mortality as a direct result of previous Reagan budget cuts.

Health services to veterans would be cut by the Administration by the use of a means test which would require veterans with pension incomes above $15,420 to contribute a significant amount to the cost of their health care. The Administration is hoping to limit veterans' access to health care and severely cut back their benefit entitlement.

Despite the nationwide support for medical research, the Administration proposes to cut funding for all institutions within the National Institutes of Health, including research on AIDS.

The Congress should provide adequate funds for the health of America's poor and elderly.

EDUCATION

The Administration's budget proposal for education most seriously affects poor and middle-income families seeking federal assistance to give their children the opportunity to attend college. Major reductions have also been proposed in the basic state grant program in vocational education. Special programs aimed at teacher improvement, women's educational equity, and grants for low-income students have been eliminated from the budget for elementary and secondary education. Once again the Administration proposes tuition tax credits and vouchers for compensatory education.

The budget proposals threaten the collapse of the Guaranteed Student Loan Program. Under the new rules, interest rates would be increased, eligibility rules restricted, and administrative costs for schools discontinued. These proposed budget cuts should be resisted by the Congress.

TRANSPORTATION

The Administration's budget cuts in transportation would undermine the nation's network of highways, railroads, mass transit systems, airways and shipping. The budget would cut $1.9 billion from the highway program which would severely constrain highway construction and repair, contribute to further deterioration in the nation's bridges and roads and cause sizable job losses in both onsite construction and in supporting industries.

The Administration's budget cuts would force Amtrak into bankruptcy by terminating its subsidy in 1987. The Administration also proposes to sell Conrail for $1.2 billion to Norfolk Southern, which would eliminate freight service on many routes in the Northeast and Midwest.

Urban Mass transit systems would be severely jeopardized by the President's proposal. The Administration wants a huge $2 billion cut in authority to a level of $1.3 billion in 1987.

The President's 1980 campaign promise to develop an effective maritime policy has been translated into a relentless war against federal water transportation programs that has issued a death warrant for the U.S. shipping industry. Early in the Administration's first term, subsidies to commercial shipbuilders were eliminated. For 1987, the Administration proposes further cuts in the water transportation budget totaling $500 million.

All aid to the six state maritime schools would terminate, except for payments previously committed to students. And after 1987, no funds would be provided for maritime research and development activities.

The Administration proposes that after 1986, the Maritime Administration provide no new guarantees for construction mortgage loans to build U.S.-flag vessels.

These proposed cuts should be resisted by Congress.

HOUSING

President Reagan's proposed budget for 1987 would eliminate federal housing and home finance programs that have helped about 20 million American families obtain decent housing over the past 50 years. The President's proposals would mark the

end of new families in urban and rural areas and drastically curtail the eligibility and increase the cost of federal mortgage insurance for middle-income families.

Economic development programs which helped provide necessary public facilities for business and housing would be eliminated or greatly curtailed.

These programs should be maintained by the Congress.

POVERTY AND HUNGER

The Administration has called for slashes in or elimination of a variety of programs which provide income, food, and urgently needed services to the poor and the disadvantaged. At a time when 33 million Americans, including one-fourth of all children, are in poverty and city officials report a sharp rise in hunger and homelessness, the Administration proposes new cuts in programs which help the downtrodden and the hungry. On top of the billions of dollars of previous reductions, the Administration's budget for 1987 demands new cuts which would force millions of the deprived even deeper into the mire of poverty and malnutrition. The commitment to the general welfare requires that Congress reject these additional cuts in programs for the poor.

GOVERNMENT WORKERS

The Administration's antagonism toward government programs is expressed in his treatment of federal workers. The budget cuts proposed by the President would put some 23,000 civilian government employees out of work in the coming year. In addition, the Administration proposes to reduce federal employee retirement and health benefits. The meager 3 percent pay raise budgeted for 1987 would fail to keep up with inflation and put government workers even further behind employees holding comparable jobs in the private sector. Currently, the pay of federal workers is 18 percent below the pay of the private sector. Congress should not allow government workers to be the scapegoat for the faulty budget proposals of the Administration.

DEFICIT

We understand the burden that deficits of the magnitude of those run in the past few years place on the economy. Such high deficits create pressure for higher than normal interest rates, raise the value of the dollar, and require a much larger share of the federal budget for interest on the debt. The high interest rates and the high dollar directly threaten jobs, and the growing interest payments on the federal debt burden present and future taxpayers and threaten to squeeze out other federal programs.

The deficit is not caused by "spending on social programs" as is charged by the President. Instead, the deficit is the result of the huge 1981 tax cuts, an economy producing far short of its potential, and the huge increase in defense spending and interest payments on the burgeoning federal debt.

The figures on government spending and tax revenues show that the deficit problem is one of a shortage of revenue rather than spending. Since the late 1960's, spending on federal programs, other than Social Security and Medicare, has increased only slightly, while tax revenues have fallen substantially.

Spending on federal programs, outside of Social Security and Medicare, rose from 16.5 percent of GNP in 1960-61 to 17.4 percent in 1986 with much of the increase in defense and interest payment on the burgeoning debt. Interest on the debt accounted for 3.4 percent share of GNP in 1986 up from 1.4 percent in 1960-61. Tax revenues, excluding Social Security and Medicare, dropped sharply from 16.0 percent of GNP to 12.4 percent. The drop was primarily due to a drop in corporate tax contributions.

The economy is operating far below its potential with 8.5 million people unemployed, and the nation's factories are operating at less than 81 percent of capacity. The sensitivity of the budget deficit to the performance of the economy is illustrated by the effect of a change in the unemployment rate. Each 1 percent increase in unemployment will raise the federal budget deficit by $44 billion—$37 billion in lost tax revenue and $7 billion in added costs of unemployment insurance payments and social costs related to joblessness. The most important step this nation could take toward reducing the federal budget deficit would be to live up to the Humphrey-Hawkins Act of 1978 and pursue every means available to put people back to work.

Interest payments on the federal debt are staggering in size. Net interest will rise from $53 billion in 1980 to $148 billion in 1987. The share of the federal budget for interest payments will rise from 9 percent in 1980 to 15 percent in 1987.

TRADE

The trade deficit is a major factor influencing the economy and, thereby, the federal budget deficit. Trade deficits are a relatively recent problem. The nation's first trade deficit in the post-war was in 1971. By the end of the 1970s, the United States was running trade deficits of $40 billion a year. In 1985, the deficit was a record $149 billion, a 20 percent increase from 1984, and a threefold increase since 1980.

The trade picture is particularly devastating for the manufacturing sector where the United States has a surplus of imports over exports as recently as 1981. Last year, the trade deficit for manufactured goods was a record $113 billion. The trade deficit in 1984 cost the economy 2.3 million jobs according to the Commerce Department. The worsened deficit in 1985 would put that total at approximately 3 million lost jobs.

The trade problem is especially severe with regard to Japan. Although the trade deficit amounted to $50 billion in 1985, no remedy has been offered by the Administration to deal with the problem.

The trade deficit has been exacerbated by the rise in the value of the dollar. The value of the dollar against the currencies of other major trading partners had increased by more than 70 percent between 1980 and 1985. While the dollar has declined during the past year, it still remains some 40 percent above 1980 levels. To avoid further economic erosion and job loss, the United States must assert control over its trade policy and the overvalued dollar.

DEFENSE

The Administration has called for further increases in the defense budget, which has doubled from 1980 to 1986, swallowing up an increasing share of the federal budget and the nation's income. At the same time, the Administration has recklessly slashed the nation's tax revenues and called for devastating cuts in vital social programs. The Administration's 1987 budget calls for a national defense budget authority of $320 billion, a 12 percent increase from 1986, and in dollars adjusted for inflation, the increase amounts to 8 percent.

The Administration argues that the proposed 1987 figure represents only a 3 percent real increase, by using as a base the $303 billion that Congress approved for fiscal 1986 in last August's budget resolution instead of the $286 billion that Congress appropriated for defense last December, minus the $5.8 billion Gramm-Rudman cut. Budget authority for national defense is projected by the Administration to grow by 41 percent over the next 5 years.

Members of Congress in both parties have charged that the Administration's budget may have underestimated defense spending for 1987 by as much as $15 billion. The House Budget Committee accuses the Administration of underestimating defense outlays by $50 to $60 billion in the years 1986 to 1991.

It is unacceptable that defense spending take place at the expense of needed social programs.

TAX POLICY

A bizarre deadlock is developing that threatens responsible budget and tax policy. President Reagan threatens to veto any tax increase while calling for major weakening of the progressive features of the House-passed tax bill and massive increases in defense spending.

Both House and Senate budget writers are seeking new revenues to lessen the harsh consequences of the Gramm-Rudman-Hollings deficit reduction scheme. All parties declare each other's proposals "dead on arrival."

Addressing tax policy at the February 1986 meeting, the AFL–CIO expressed support of the House-passed tax reform measure as a means for providing a more equitable tax structure and to serve as a basis for raising more tax revenue. The AFL–CIO Executive Council stated:

"The AFL–CIO urges the Congress to resolve this stalemate by adopting the constructive provisions of the House-passed Tax Reform Act of 1985 and to build upon that revenue-neutral bill by raising additional revenues to meet the nation's needs and combat the federal budget deficits. This can be accomplished without taxing middle-class protections such as employer-provided benefits and without eliminating the deduction for state and local taxes. Nor is there any justification for creating new inequities through the enactment of value-added taxes, selective excise or consumption taxes which bear most heavily on low- and middle-income working families."

The House-passed bill will curb many of the tax loopholes that provide excessive benefits to the wealthy and corporations, and the House bill rejects many of the Administration's proposals which would harm working people and their communities, such as the taxation of health care benefits, life insurance, death benefits, legal services, education and disability compensation, and the elimination of the deduction of state and local taxes.

Problems still remain in the bill concerning income averaging, unemployment compensation, and provisions affecting public employees.

Measures must be taken to raise additional revenue as part of the effort to provide true tax reform and fiscal responsibility. We urge Congress, in completing action on the tax bill, to adopt revenue measures which would raise $41.5 billion in the first year after enactment and more than $200 billion over the first 5 years. The AFL-CIO urges adoption of the following tax measures:

1. Establish a 45 percent tax bracket.
2. Curb the reduction in the corporate tax rate to 41 percent.
3. Reduce the preferential treatment for capital gains.
4. Curb privileges of the oil and gas industry.
5. Transform the foreign tax credit to a deduction and limit deferability.
6. Curb tax shelters.
7. Raise the individual and corporate minimum tax.
8. Reject the proposal for a 10 percent corporate deduction for dividends paid.

Based upon this analysis of the nation's needs and resources, the AFL-CIO urges the Congress to reject the budget cuts in social programs, to resist the proposed massive buildup in defense spending at the expense of social programs, and to meet the deficit reduction targets by mitigating the sharp tax rate reductions for the wealthy and corporations and by further closing of preferential tax treatment of multi-national corporations and the wealthy.

STATEMENT BY THE AFL-CIO EXECUTIVE COUNCIL ON BUDGET

The President's budget amounts to an ideological assertion that the federal government's only responsibility is to provide for the common defense. It ignores the Constitutional requirement to promote the general welfare.

His budget proposes to cut general government programs to pay for substantially increased defense spending and to meet the deficit targets specified in the Gramm-Rudman-Hollings Act.

In spite of the overwhelming evidence of revenue shortfalls, the President threatens to veto any legislation that would raise funds to pay for essential federal programs.

The President proposes to sell off a number of the government's assets through a program that he calls privatization. He would get rid of Bonneville Dam, the Naval Petroleum Reserves, Amtrak and other governmental assets. He proposes to eliminate such programs as Trade Adjustment Assistance, Urban Developmental Action Grants, General Revenue Sharing, Economic Development Assistance and special help for the Appalachian Region, the Small Business Administration, new construction for assisted housing programs, selected maritime subsidies, the Legal Services Corporation and the Interstate Commerce Commission.

He proposes major cuts in assistance for dislocated workers, the Job Corps, summer youth employment programs, vocational education, student aid, Medicare, Medicaid, Child Nutrition Subsidies, Food Stamps, Aid to Families With Dependent Children, as well as the Special Supplemental Food Program for Women, Infants and Children, and Veterans Medical Care. He also proposes to continue to scapegoat federal employees through dismissals, curtailment of wage increases, increases in pension contributions and reductions in retirement benefits.

The Gramm-Rudman-Hollings approach to the 1987 budget is as dangerous as the President's. The massive across-the-board cuts that it prescribes are no more acceptable and no less irresponsible than the cuts proposed by the Administration.

The AFL-CIO calls upon the Congress to:

Refuse to increase defense spending at the expense of domestic programs. If Congress determines that some program reductions are necessary to impose budgetary restraints, defense spending must not be exempted from such cuts.

Reject the elimination of the government role in support of the general welfare of all Americans, including workers, their children, their parents and the poor.

Raise additional tax revenue, based on fair taxation, as the only alternative to unacceptable budget cuts.

Repeal the Gramm-Rudman-Hollings Act.

Statement by the AFL-CIO Executive Council on Tax Policy

A bizarre drama is unfolding in Washington.

President Reagan threatens to veto any tax increase while calling for major weakening of the progressive features of the House-passed tax bill and massive increases in defense spending.

Senate tax writers are seeking new sources of revenue to offset losses expected if they give back to corporations and wealthy individuals tax breaks that were taken away in the House bill.

At the same time, both House and Senate budget writers are seeking new revenues to lessen the harsh consequences of the Gramm-Rudman-Hollings deficit reduction scheme. All parties declare each other's proposals "dead on arrival."

The AFL-CIO urges the Congress to resolve this stalemate by adopting the constructive provisions of the House-passed Tax Reform Act of 1985 (H.R. 3838) and to build upon that revenue-neutral bill by raising additional revenues to meet the nation's needs and combat the federal budget deficits. This can be accomplished without taxing middle-class protections such as employer-provided benefits and without eliminating the deduction for state and local taxes. Nor is there any justification for creating new inequities through the enactment of value-added taxes, selective excise or consumption taxes which bear most heavily on low- and middle-income working families.

The House-passed tax bill contains many provisions long advocated by the AFL-CIO to curb loopholes and limit the special privileges of the wealthy and the corporations. Taxes are lowered for many who have been paying more than their fair share, and 6.5 million poverty-stricken Americans would be removed from the rolls.

The House bill explicitly rejects many of the Administration's proposals which would have hurt workers and the communities in which they live. However, unduly harsh provisions affecting public employees, unemployment compensation recipients and workers with job related income averaging problems remain in the bill and must be rectified in the Senate.

We are particularly pleased that the House of Representatives repudiated the Administration's attempt to levy a tax on working people's health care, life insurance, death benefits, legal services, education and disability compensation; and chose to retain the existing deduction for state and local taxes, thereby protecting the citizens of those localities which have assumed the responsibility for high-quality education and other public programs.

We believe that the needed additional revenues can be raised without harm to middle- and low-income taxpayers. Congress, in completing action on the tax bill, should:

Establish a 45 percent fourth tax bracket;
Curb the reduction in the corporate tax rate;
Reduce the preferential treatment for capital gains;
Curb privileges of the oil and gas industry;
Transform the foreign tax credit to a deduction and limit deferability;
Curb tax shelters;
Raise the individual and corporate minimum tax;
Reject the proposal for a 10 percent corporate deduction for dividends paid.

By taking these steps, the Congress could raise $41.5 billion in the first year after enactment and more than $200 billion over the first 5 years while taking major strides toward true tax reform and fiscal responsibility.

Fact Sheet on Tax Policy

The details of the AFL-CIO proposed tax changes:

1. Raise the fourth bracket from 38 percent to 45 percent for those individuals with $100,000 in income filing joint returns. Such a move could raise $4.3 billion in the first year after enactment.

2. Curb the reduction in the corporate tax rate to 41 percent instead of the 36 percent contained in H.R. 3838. This would raise $12.5 billion in the first year.

3. Reduce the preferential treatment for capital gains. By reducing the exclusion for capital gains from 42 percent (contained in H.R. 3838) to 40 percent combined with the proposal for an individual rate of 45 percent, the Congress could raise an additional $4.1 billion in the first year.

4. Curb the privileges of the oil and gas industry. H.R. 3838 contains only a portion of the reforms proposed in the original Treasury plan. Returning to that proposal would raise $6.2 billion in first year revenues.

5. Transform the foreign tax credit to a deduction. The existence of the foreign tax credit combined with the deferral privilege encourages U.S. firms to invest, produce and create jobs overseas. By building on the provisions of H.R. 3838, the Congress would raise $9.7 billion in first year revenues.

6. Impose a minimum tax of 25 percent on all corporate income over $150,000 and all individual income over $100,000. This provision would raise $4.2 billion over the House-passed bill.

7. Curb tax shelters. By adopting the Treasury I proposal to tax large partnerships, as the corporations that they are in all but name, the Congress could raise $300 million in the first year after passage.

8. Reject the proposal for a 10 percent corporate deduction for dividends paid. This provision would cost the Treasury $200 million per year for something that corporations would do in any event: distribute dividends to their shareholders.

Total Revenue: $41.5 billion

PREPARED STATEMENT OF KENNETH T. BLAYLOCK, NATIONAL PRESIDENT, AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES, (AFL-CIO)

The American Federation of Government Employees (AFL-CIO) is pleased to submit this statement to the House Budget Committee on the President's fiscal year 1987 budget proposal.

Clearly the coming months will be difficult times for the Congress and this Committee. Federal employees will be facing frightening times in the coming months. Federal employees wonder if the retirement system they had looked forward to and counted on will still be intact. They wonder if their health insurance will once again be downgraded. They worry about how they are to meet their bills in retirement when their pension may not even keep up with inflation. These are troubling times for all of us.

The driving force behind our current problems is the massive budget deficit which went from $40 billion in fiscal year 1979 to $200 billion plus for fiscal year 1985 and fiscal year 1986. The general long-term causes of the deficit are clear. General revenues (net of Social Security and Medicare) dropped from 16.1 percent of GNP in 1960 to 12.6 percent in 1986. (In looking at outlays and revenues, the most appropriate economic frame of reference is a percent of GNP which is what is used in the following analysis.)

At the same time, outlays increased slightly from 15.9 percent of GNP in 1960 to 17.6 percent in 1986. These long-term trends were sharply accelerated by the fiscal policy adopted in 1981. General revenues dropped by a full two percentage points of GNP while defense spending increased 1.2 percent. Because of these two trends, net interest went up an additional 1.0 percent. Domestic spending, far from being "the cause" of the deficit, actually declined by 1.3 percent.

In the context of overall revenues, we want to emphasize that corporate taxes, which were 23.2 percent of total revenues in 1960, plummeted to 8.3 percent in 1985.

The underlying causes of the deficit are revealed as falling general revenues and, in particular, falling corporate taxes and the recent escalation in spending on weapons programs.

Instead of addressing the causes of the deficit in a straightforward and realistic manner, the Administration seeks a deficit solution in a series of initiatives outlined in its budget document entitled Major Policy Initiatives.

Under the category of "Privatization", we see a set of proposals to sell government assets to the private sector. We call this strategy: "Selling the house to pay the mortgage."

Under the category of "Federalism" are proposals to turn over expensive national programs to the states. We call this strategy: "Let the states raise taxes".

Under the category of "Charges for Government Services", we see various proposals to charge user fees for government services thereby restricting those services to those who can afford them. We call this strategy: "Government for hire".

Under the category of "Elimination of Programs", we see proposals which basically abandon entire areas of social need from effective government action. We call this strategy: "Let's close our eyes and pretend the problems are not there".

Under the category of "Social Service Reforms", we see once again a set of proposals to cut programs for the poor and unemployed. This can be referred to as the: "Kick'em, while they're down" strategy.

None of these so-called strategies addresses the underlying causes of the deficit—falling revenues and excessive spending on weapons programs.

Finally, under "Government Management Reforms", we see a continuing effort to destroy the government's personnel system. For the record, these proposals are:

PAY

A 3 percent increase in January, but offset by a 2 percent increase in retirement contributions for a net increase of an insulting 1 percent.

RETIREMENT

Increase normal retirement age to 62 with a 2 percent penalty per year for retiring before age 62. A thirty-year employee retiring at age 55 will have his or her annuity reduced by 14 percent.

Base annuity calculation on high five years of earning instead of the current high three years of earnings.

Elimination of the January, 1987, COLA.

Elimination of all future full COLAs and replacement of full inflation protection with a CPI minus two formula (no similar proposal was offered for other indexed retirement programs).

Reduce survivor, adult student, and minimum benefits by conforming them to Social Security.

The sum of all these retirement cuts is a $674 million reduction of fiscal year 1987 for federal employees or retirees.

HEALTH BENEFITS

In a minor revision of the Administration's discredited voucher plan, they propose to base the government contribution on a program-wide average instead of the current six largest plans. They would then index this amount by the GNP deflator. Employees would be forced to bear an increasing share of the cost of their health insurance since the GNP deflator has historically gone up much slower than health care costs.

Other proposals would encourage employees to opt for inadequate, cut-rate, health insurance plans. The government's contribution for health insurance would be decreased by some $110 per employee for a total reduction of $322 million.

JOBS

Eliminate 23,400 jobs in civilian agencies.

Increase the number of jobs slated for Contracting-Out study by thirteen times in domestic agencies and by three and a half times in the Department of Defense.

These proposals are an insult to federal employees who have served the American people so well. Generations of civil service workers have carried on the day-to-day nuts and bolts of government operations through good times and bad times, during peace and war, in depressions and booms, and through periods of stability and during political upheavals. These proposals slander all the government employees who have served with dignity, pride and distinction.

We hope this Committee will reject all of these ill-considered, short-sighted proposals.

PAY

The history of federal pay under the Pay Comparability Act is a history of broken promises. Since the passage of the Pay Comparability Act in 1970, pay for federal workers has lagged behind every significant economic indicator including private sector wages, inflation, military pay, and state employee compensation.

When inflation was high, federal employees were told they had to hold down their pay to set an example for the rest of the country. When there was recession, federal employees were told that there wasn't enough money for the pay raise they deserved. Now inflation is low, the economy is growing, and federal employees are offered a net pay increase of 1 percent. Since employees would be taxed on the full three percent nominal pay raise, their take home pay would not increase the full 1 percent, and in some cases would actually fall.

RETIREMENT

Many federal employees have tolerated less pay and benefits than they deserve because of the promise of a decent retirement. It would be an outrage if, after con-

tinuing for their working life in the Civil Service because of the CSRS, they have their retirement pulled out from under them as they near retirement age.

Retirement is just one part of a compensation package. All independent analysts (Hay Associates, GAO, etc.) have found that the total compensation package is significantly behind their private sector counterparts. Clearly, the Administration's proposals will worsen this inequity.

HEALTH BENEFITS

The Administration's proposals, if passed, would pose a cruel ultimatum to federal workers:

Either pay more for your health coverage *or* accept inadequate health insurance coverage for yourself and your family.

We hope this Committee will avoid posing this cynical question to federal employees.

CONCLUSION

Federal employees and the services they deliver will not avoid continual reduction and continual attack until the underlying causes of the deficit are resolved. In this regard we note Congress is not blameless. Congress voted for the massive tax cuts in 1981. Congress ratified the expansive spending on military weaponry, and most recently Congress overwhelmingly passed the Gramm-Rudman-Hollings Legislation. Given this history of Congressional abdication of its political responsibility, we turn to Congress to take the lead in redressing the underlying deficit momentum.

It is incumbent upon Congress to take the lead in securing the revenues to provide the American people the programs and services they deserve. It is clear that the initial and most important area to turn to is the erosion of the tax base created by the historic fall in corporate revenues. Estimates show that the passage of a corporate minimum tax similar to that in the House-passed Tax Reform bill (without any other changes in tax law) would raise $35-40 billion per year.

The AFL-CIO has put forth a number of other proposals to boost the revenue side of the federal budget. We hope that Congress will not shirk from its political responsibility and move forward with revenue proposals.

The message that AFGE, as a union of federal employees, is trying to get across to Congress is that the work of government employees is valuable—that the services they provide are important and deserve to be funded.

Thank you.

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF REGIONAL COUNCILS

The National Association of Regional Councils (NARC) appreciates the opportunity to provide testimony to the Committee on the Administration's fiscal year 1987 budget proposals.

NARC represents approximately 300 of the 534 existing substate regional councils currently in operation in the United States. Regional Councils are public agencies encompassing a regional community—founded, sustained and tied directly to local governments through local and/or state government actions. Through communication, planning, policy-making, coordination and technical assistance, councils serve the local governments and citizens in a region by dealing with issues and needs which cross city, county and, in some instances, state boundaries. They are found in both urban and rural areas.

The policy-making boards of regional councils are composed mostly of elected officials representing local governments within a substate region. In some states, representatives of the state legislature and citizens sit on their local regional council boards.

Regional councils provide assistance to their communities in areas ranging from transportation to economic development to job training to meals for the elderly. Geographically, councils often span several counties and can involve hundreds of local governmental jurisdictions.

As the Committee can see by this brief overview of regional councils, they are an integral part of our intergovernmental system.

About one month ago, NARC convened a meeting of about 800 elected officials and regional council staff from around the country. The meeting was held here in Washington and its theme was "The Fiscal Crisis." Its focus was Gramm-Rudman-Hollings and the budget process.

That meeting was dominated by concern about severe budget cuts in domestic programs, particularly the elimination of General Revenue Sharing, curtailment of federal mass transit expenditures and pollution control assistance, and dismantlement of the Economic Development Administration and the Small Business Administration.

As we told the Committee during the FY86 budget hearings, these programs are essential to the economic vitality of state and local governments. In many cases, these federal funds assist state and local governments in complying with federal mandates (e.g. clean water, etc.). In other cases they promote business development and jobs.

Most importantly, federal domestic programs for state and local governments have, historically, been instituted to achieve some national purpose and in recognition of the disparate nature of the state and local government members of our federal system. They were developed to accomplish clear policy objectives.

The fiscal year 1987 budget proposed by the Administration is offered in the absence of such policy considerations.

Moreover, the Administration proposals for fiscal year 1987, as in years past, do not recognize the impact these cuts will have on the national economy. The Administration's fiscal year 1987 proposals do not recognize the catalytic role that federally-assisted development programs play in promoting public/private partnerships. And the Administration's budget proposals for fiscal year 1987 do not recognize that loss of federal programs could very quickly turn small state budget surpluses to large deficits as state and local governments struggle to maintain services and meet federal mandates in the absence of federal assistance.

As NARC has told this panel in the past, the state and local government leaders represented through NARC continue to be disturbed by the Administration's "number-driven" approach to public policy development. It is superficial and inappropriate.

CONSIDER PROGRAMS ON THEIR MERITS

The relationship of our federal government to its state and local partners can be viewed as a tapestry woven over many years. All parts are interdependent. What happens in the states impacts the national economy. National decisions certainly have a major affect on how state and local governments function.

NARC will be among the first to admit that some parts of that fabric—some federal assistance programs to state and local governments—have outlived their usefulness or are currently having little impact. But the elimination or continuation of state and local assistance programs should be considered in terms of their value to the nation, not because those programs are in one of the few parts of the budget that can be cut with relative political ease.

We need to examine programs to see if they are carrying out their purpose in an efficient, effective manner. And most importantly, we should ask whether they adequately assist in fulfilling national goals. In austere times, we must make policy-based assessments concerning which programs should remain and which should go, which are necessary and which have outlived their usefulness.

But such decisions must be made through a process which allows for reasoned examination of these programs. It is not acceptable—nor is it good public policy—to make decisions on the basis of numbers alone. Budget and deficit reductions—no matter how urgently needed—should not be the preeminent basis for such choices.

FEDERAL DEFICIT MUST BE ADDRESSED

Of course, all policy considerations will be somewhat impacted by the budget and the need to curtail the deficit. Gramm-Rudman-Hollings mandates cuts to address this problem. But even this approach is not an equitable one because it shields many elements of the budget from sharing in the overall reduction.

At our February meeting, NARC's Board of Directors reaffirmed a resolution which confronts the dilemma of the budget deficit. Last year we presented this proposal to the Committee; but perhaps the sense of urgency was not as strong as it is now.

NARC believes that it essential for the country's economic health to not only curtail the deficit, but to do it in a fashion that will not cause cuts to fall disproportionately on vulnerable segments of the budget like state and local government assistance.

Therefore, we ask the Committee to immediately assume a leadership role:

(1) in promoting a bipartisan across-the-board freeze in Federal spending at the budget levels established for fiscal year 1986 (after Gramm-Rudman's March 1 cuts),

while urging the tax-writing committees to develop a bipartisan and comprehensive tax reform package which would produce the new revenue needed to reduce the budget deficit and avoid further cuts in domestic spending; and,

(2) in conjunction with the freeze and tax package, urging the Administration and the Congress to undertake a bipartisan POLICY-BASED review of existing major domestic programs to assess their effectiveness in meeting fundamental national needs and purposes.

LOOKING AT THE LONG-TERM HEALTH OF THE INTERGOVERNMENTAL SYSTEM

It does not serve the nation well in the long term to hastily eliminate programs for solely budgetary reasons. These programs were created to implement policies that were undoubtedly the product of lengthy Congressional deliberations. They were not developed as aimless vehicles for transferring revenues from one level of government to another and they should not be aimlessly cut to trim the federal government's "bottom line."

We urge the Committee to take up the challenge of promoting a better solution to the budget problems we are facing. The budget should not be driven only by the numbers; it is so much more than that. It is a policy document with real-life consequences for the economy and our intergovernmental system.

Undeniably, NARC's proposed approach will take political courage. If embraced by the Committee, it would bring short-term criticism from various corners. But this strategic approach to budget balancing has the long-term benefit of preserving the intergovernmental tapestry while altering it in a prudent fashion. It represents a solid plan for the nation's future rather than a continuance of the "band-aid" approach to the budget that we have been using over the past five years. It's good common sense and it's good public policy.

NARC and its members stand ready to assist you in this effort.

Thank you.

PREPARED STATEMENT OF C. H. DEAN, JR., CHAIRMAN, TENNESSEE VALLEY AUTHORITY

Mr. Chairman, I am pleased to submit for your consideration our views on the Tennessee Valley Authority's importance to the Valley region and the Nation and, as you requested, a comparison of the Administration's budget request for TVA for fiscal year 1987 with the enacted 1986 budget.

The Tennessee Valley Authority faces sharp reductions in its appropriations-financed budget request for fiscal year 1987. The Administration's 1987 request of $58.038 million compares to the $125 million appropriated to TVA in year 1985 and to the $113 million appropriated to TVA in fiscal 1986. Including $12.4 million in unobligated balances available from 1985, TVA had available a total of $125.4 million at the beginning of fiscal year 1986. However, sequestration under the provisions of Gramm-Rudman-Hollings has resulted in a decrease of $4,472,000, resulting in an across-the-board reduction in each program area. In its request to OMB for fiscal year 1987 TVA requested $114 million, a current services level, as set forth in the attached table.

Mr. Chairman, I would like to detail the Administration's proposal for 1987.

NATURAL RESOURCES

The fiscal year 1987 request includes $26.893 million in support of natural resource programs. This decrease from the $48.512 million ($46.636 million after the sequestration required by Gramm-Rudman-Hollings) available for fiscal 1986 is a result of reductions in all natural resource programs and the elimination of funds for the operation of the Land Between The Lakes outdoor recreation and environmental education facility. This request will fund the following activities:

Reservoir System Operations.—The requested $20.5 million for this work compares with $23.691 million ($22.771 million per G-R-H) in 1986 and will provide funds to meet safety and operational requirements related to ownership of the reservoir system, including the navigation and flood control needs. A number of property management responsibilities, such as road and building maintenance, timber and wildlife management, property encroachment protection, and cooperative planning for private and public development along or on TVA lands, also would be stretched out.

Water Resources.—The Administration's request is $3.5 million, a reduction from $8.4 million ($8.053 million per G-R-H) available in 1986 and $13.2 million in 1985. At reduced levels, TVA would continue monitoring selected pollutants in reservoirs

and tributaries, cooperative clean-up of long-term contamination in tributaries, joint implementation with States of reservoir water quality management plans, and improve dissolved oxygen levels in tributaries and below TVA dams. Other water resource activities involving innovations and demonstrations of national consequence, as well as those of regional resource stewardship and development, would be terminated. These include the environmentally sensitive areas of ground water protection, wastewater management, coldwater fisheries habitat improvement, and assistance in solving emerging and existing issues in local floodplain management. The Administration proposed that these activities be supported by other Federal, State, and local agencies.

Land and Forest Resources.—The 1987 request of $550,000 is in contrast to the $4.3 million ($4.130 million per G-R-H) available in 1986 and the $5 million in 1985. The 1987 request would be used exclusively for pumping and regulating water levels in wetlands adjacent to mainstream TVA reservoirs. Demonstrations in such areas as soil erosion control and raptor restoration, improving forest productivity, development of regional recreation potential, and support for a regional university network providing environmental skills would be terminated. The Administraiton proposed that these activities be supported by other Federal, State, and local agencies.

Resource Management and Development Support.—The 1987 request is $2.25 million, down from the $5.1 million ($4.970 million per G-R-H) available in 1986. This request would continue TVA's work producing maps of the Valley region, as part of the USGS National Mapping Program, and activities that ensure TVA compliance with Federal and State environmental management regulations. Also funded would be studies and monitoring on the effects of acid rain on the region's land and forest resources. Activities in air quality management, toxic air monitoring and control technology, and hazardous and solid waste management would be eliminated. The Administration proposed that these activities be supported by other Federal, State, and local agencies.

Land Between The Lakes.—The Administration's 1987 budget requests no funds for operating or maintaining the 170,000-acre Land Between The Lakes outdoor recreation, land management, and environmental education demonstration and resource development facility. This compares to a budget of $7 million ($6.712 million per G-R-H) in 1986. The Administration proposes that these activities be funded from fees and/or State financing if possible.

In response to your request for an assessment of these proposed reductions, I must point out that TVA's natural resources program revolves primarily around the management and use of the largest operationally integrated system of water and related resources in this country. Closely related is an effort to protect and enhance the Valley's natural resources so as to provide a base for economic development and a quality living environment.

TVA takes seriously its stewardship responsibilities for ensuring that these assets serve the needs of the American public in a way that preserves their long-term environmental quality and their economic utility. In so doing TVA strives not only to maximize the benefits of the system, but to offer a national model of state-of-the-art, integrated resource management. In its outreach efforts, TVA supplements the work of the Valley States, other Federal agencies, and the private sector to attack resource issues such as toxic contamination of surface and ground water supplies, water quality, acid rain effects, wetland protection, forest management, land reclamation, and environmental education.

The funding level proposed for fiscal year 1987 would curtail the broader, more integrated approach TVA has traditionally taken.

Specifically, because the ultimate burden for solving most resource problems lies outside the Federal Government, TVA has focused on innovations and demonstrations as the means that enable its Valley partners to successfully assume their own responsibilities. Moreover, TVA does not isolate its responsibilities in the Valley from its Federal mandate. TVA therefore makes a special effort to apply its limited resources to issues that have wide applicability, significant benefit, and timeliness as recognized by leaders and experts across the Nation and abroad.

ECONOMIC RESOURCES

TVA's economic resources programs support activities in the private sector and at the local, State, and Federal levels to attack stubborn economic problems and to anticipate needs and opportunities that are emerging as the Nation's economy evolves. TVA's assistance is principally of a technical or educational nature, and thereby avoids building dependence on direct financial aid from Federal sources and reduces the need for Federal transfer payments to individuals.

No funds are requested in fiscal 1987 by the Administration for economic resource programs. This is a part of the Administration's effort to eliminate local/regional economic development programs Government-wide. Congress supported these programs in 1986 with total funding of $15.5 million ($14.896 million per G-R-H), a reduction from the 1985 funding level of $19.7 million.

AGRICULTURAL RESOURCES DEVELOPMENT

The Tennessee Valley is predominately rural, and farming is a way of life for many of the region's residents. The Valley's farmers face a number of challenges, some brought on by changes in the economy, others by changes in technology. TVA has provided support to these farmers, the region's land-grant universities, and other State and local organizations to help keep farming a viable enterprise, a continued source of employment, and a solid contributor to the Valley and the national economy.

The 1987 Budget Program proposes no funding for the agricultural resources development program, which was financed with a $5.1 million ($4.931 million per G-R-H) appropriation in 1986. Again, this reflects the Administration's effort to terminate regional economic development. Eliminated would be: demonstrations to improve efficiency, farm management, and marketing development for poor, rural farm families; demonstrations to introduce alternative enterprises on marginal and low-income farms as a way to increase family farm income; cooperative marketing opportunities that improve the efficiency of current marketing facilities through electronically disseminated marketing information; demonstrations on controlling soil erosion and promoting water quality improvement of Valley streams and TVA reservoirs while maintaining farm income; and the home garden program.

NATIONAL FERTILIZER DEVELOPMENT

TVA is the world's undisputed leader in fertilizer research and development. In the past half-century, TVA has been responsible for 75 percent of the fertilizer technology used today. With fertilizer accounting for at least 40 percent of agricultural production, the U.S. has been able to grow an abundance of food and fiber for its own people as well as for export. TVA's National Fertilizer Development Center is the centerpiece of a highly successful Federal-state-private sector partnership that combines research, development, and commercialization of affordable, effective, energy-efficient, and environmentally sound fertilizer processes and products.

The program is geared to adapt the change—whether in the economy, resource availability, or public policy—and to accelerate positive change in industry and farming practices. Accordingly, TVA's research program will continue to develop efficient techniques to recover and process lower grade indigenous phosphate ores. It will make production of both conventional and new fertilizer materials more energy efficient, less polluting, and economically viable. Another research priority is to ensure that fertilizers are compatible with diverse agronomic needs and farming practices. TVA will also continue research on improving efficient crop use of fertilizer nutrients, especially costly to produce nitrogen. Finally, to promote and accelerate the transfer of research results, TVA will continue its longstanding and productive working relationship with industry firms to test the agronomic and engineering qualities of experimental products and to produce sufficient amounts of the new products to create and evaluate market acceptance.

The Administration's 1987 Budget Program requests a total of $20.635 million for National Fertilizer Development activities. This is a reduction from the $33.1 million ($31.825 million per G-R-H) available for TVA for fiscal year 1986. Eliminated from the 1987 program would be all research aimed at developing a commercially viable technology for conversion of hardwood to liquid fuels, which was funded at a $3.4 million level in fiscal 1986. Included in the 1987 request are:

Fertilizer Research and Development.—The request for laboratory and in-plant research and development activities is $10.43 million, compared to $16.9 million ($16.275 million per G-R-H) available to TVA in fiscal year 1986. Generally, the reduction reflects efforts to obtain greater cost-sharing in projects.

Technology Development.—Requested funding for TVA's national fertilizer technology development program is $10.2 million in 1987, a decrease from the $12.6 million ($12.085 million per G-R-H) available in 1986. Under the 1987 program. Increased private sector funding would be sought through a combination of cost-sharing and greater cost recovery from the sale of experimental fertilizers.

It is important to note that TVA's program reflects responsiveness to the recommendations of the President's Private Sector Survey on Cost Control. TVA is making every effort to identify the kinds of services which private industry would

be willing to pay for and to seek joint ventures with private firms for final development of certain technologies. A prime example is a cooperative project with the Florida Institute of Phosphate Research and the W. R. Grace & Company, whereby a portable process will be constructed and used to demonstrate new TVA technologies for recovering lower grade phosphate.

CAPITAL INVESTMENT

The request for capital investment funds for 1987 totals $9.843 million. This is a reduction from the $21.5 million ($21.043 million per G-R-H) available in 1986. Included in the current request are $2.6 million to continue modifications at TVA dams to bring them up to currently acceptable national safety standards; $1.5 million for routine additions and improvements at TVA multipurpose dam projects; $4.4 million for needed capital improvements at the National Fertilizer Development Center; and $1.3 million for general office, transportation, and laboratory facilities and equipment.

Eliminated from the 1987 capital request, as compared to 1986, would be funds for improvements at Land Between The Lakes, and new recreation facilities.

No new capital investment projects are requested for 1987.

GENERAL SERVICES

The request for funding for general services is $667,000 in 1987, a reduction of approximately 56 percent from the $1.5 million (the same for G-R-H) available for 1986. The majority of the 1987 estimate ($609,000) is for annual maintenance on five bridges financed by DOT and constructed across TVA dams. The remainder of the estimate ($58,000) is for the preparation and maintenance of emergency fallout shelters in TVA facilities.

POWER PROGRAM

TVA's power program, of course, is completely self-financed from revenue and revenue bonds and does not receive appropriations.

TVA's power program has performed well in most areas during the past year, although our nuclear program has experienced major and widely publicized reversals. The availability and efficiency of our fossil fuel plants have been outstanding, and we have been able to meet all power demands of the region, despite the loss of our nuclear generation, without major problems. Our hydroelectric plants, although performing well, experienced a significant drop in production last year because of the most severe drought on record in the Tennessee Valley.

Electric rates remained virtually unchanged for three years in a row, before rising a relatively modest 6.9 percent at the beginning of the current fiscal year.

A negative note in our power program last year concerned our nuclear plants. There we experienced persistent safety-related and management problems that resulted in the Board's decision to shut down our two operating plants and delay our licensing request on a third plant until these problems are fully identified and resolved.

We cannot project at this time when these problems will be resolved and the plants can be returned to service. But the Board has taken action to correct the problems and get TVA's nuclear program back to the leadership position it once enjoyed in the industry. The Board has brought in Retired Admiral Steven A. White, who has had many years of experience in the nuclear Navy, and delegated to him the authority and responsibility to find and fix the chronic problems that have brought our nuclear program to a halt.

Despite the problems with our nuclear program, the TVA power system is continuing to serve a valuable national demonstration role in conservation, energy management, research and demonstration, and environmental protection.

Conservation programs in the TVA region show potential for reducing electricity consumption by 11.6 billion kilowatthours by the year 2005. TVA has reached its fiscal year 1985 goal for solar water heaters with nearly 1,600 installations. Since the beginning of TVA's conservation program in 1977, 935,000 consumers have received free energy surveys, and more than 500,000 homes have been weatherized under TVA's energy conservation program.

A significant milestone was reached last September in TVA's cooperative program to test and demonstrate advanced technologies that can help the electric power industry improve its performance and meet future demands in economical and environmentally acceptable ways. The Nation's electric power industry, government, and the transportation and coal industries joined TVA at our Shawnee Steam Plant

near Paducah, Kentucky, to break ground for the Nation's first full-scale test of the atmospheric fluidized-bed combustion process for burning coal to generate electricity. The process, which has been tested in a smaller pilot plant at Shawnee, promises a cleaner and more efficient way to use the Nation's plentiful high-sulfur coal supply in electric power plants. TVA's successful tests of ways to improve the dissolved oxygen levels in releases from large hydroelectric dams are attracting the attention of dam operators across the country, while TVA's cooperative work on the causes and effects of acid rain also is part of a national effort.

SUMMARY OF BUDGET FINANCED FROM APPROPRIATIONS

[Obligations in thousands of dollars]

	1986		1987
	Before G-R-H	After G-R-H	TVA request
CAPITAL INVESTMENT			
New lock at Pickwick Landing Dam	709	709	
Columbia Dam and Reservoir	863	863	
Dam safety modifications	5,947	5,857	2,610
Additions and improvements	3,957	3,864	2,358
Recreation facilities	250	240	250
Land Between The Lakes	110	106	95
Chemical facilities	5,391	5,191	5,050
North Alabama coal to methanol	1,935	1,935	
General facilities	7,359	7,278	2,052
Total capital investment	21,516	21,043	12,415
OPERATING EXPENSES			
Natural resources:			
Water resources	8,376	8,053	8,001
Reservoir system operations	23,691	22,771	24,050
Land and forest resources	4,300	4,130	4,300
Resource management and development support	5,160	4,970	4,805
Land Between The Lakes	6,985	6,712	6,900
Total natural resources	48,512	46,636	48,056
Economic resources	15,505	15,046	13,710
Agricultural resources development	5,136	4,931	4,436
National fertilizer development:			
Fertilizer R&D	16,900	16,275	19,300
Fertilizer technology development	12,605	12,085	12,385
Ammonia from coal	200	200	
Hardwood fuels research	3,400	3,265	3,400
Total national fertilizer development	33,105	31,825	35,085
General services	1,545	1,366	799
Total operating expenses	103,803	99,804	101,585
Jobs bill	81	81	
Total appropriations	125,400	120,928	114,000

NATIONAL TAXPAYERS UNION,
Washington, DC, February 24, 1986.

Hon. WILLIAM GRAY,
Chairman, House Budget Committee, Washington, DC.

DEAR MR. CHAIRMAN: I would like to submit the enclosed materials to your committee, and I ask that they be included in the hearing record you are preparing with regard to the President's FY 1987 budget.

As indicated in the materials, the National Taxpayers Union has filed a class-action lawsuit, on behalf of America's 50-million children, alleging that the current pattern of excessive deficit financing violates plaintiffs' rights to equal protection of

the laws. William Bonner and six other named child plaintiffs filed this lawsuit in the district court for the District of Columbia on January 14, 1986. Joining this action are two state attorneys general—a Democrat from West Virginia (who is "of counsel") and a Republican from Utah (whose one-year-old daughter is a plaintiff).

I would be pleased to provide your committee with more information about this case, if your wish.

Sincerely,

JAMES DALE DAVIDSON, *Chairman.*

SUMMARY OF BONNER V. BAKER—A CLASS ACTION LAWSUIT CHALLENGING THE CONSTITUTIONALITY OF TODAY'S FEDERAL DEFICITS

1. INTRODUCTION

This action challenges the constitutionality of actions taken by recent congresses and presidents to incur massive budget deficits to pay the current costs of government, without any present intent or ability to retire this debt, and in the absence of any compelling governmental interest (i.e., a very good reason) to support such financing.

Important precedents for the *Bonner v. Baker* lawsuit were established by a series of 1985 U.S. Supreme Court equal protection decisions, notably *City of Cleburne v. Cleburne Living Center, Williams v. Vermont,* and *Hooper v. Bernalillo County Assessor.* These cases indicate that, when a law imposes discriminatory burdens on a class of persons, and when those burdens bear no rational relationship to the relevant characteristics of those persons, that law must serve a compelling governmental interest in order to be constitutional.

The laws which produce today's deficit financing fail this test. They impose discriminatory burdens on today's children. Those burdens bear no rational relationship to any relevant characteristics of children. And, in the present era of peace and prosperity, no compelling governmental interest is served by this scheme of borrowing.

2. TODAY'S CHILDREN SUFFER DISCRIMINATORY HARM FROM MASSIVE BUDGET DEFICITS

Federal borrowing shifts part of the cost of government from present taxpayers to future taxpayers.[1] America's founding generation frowned upon the accumulation of what they called "perpetual debt,"[2] that is, a debt which is never paid off. But the accumulation of such debt is politically attractive for presidents and members of Congress. The benefits of deficit financing are immediate and tangible, and accrue to current taxpayers—99 percent of whom are of voting age. By contrast, the burdens are distant, not well understood, and fall on future taxpayers, many of whom—including today's children—cannot vote.

As non-voting minors, children are not directly represented in the political debate; they must rely on today's voters to protect their interests. In the case of today's deficits, however, a unique circumstance arises—the interests of today's children are distinctly adverse to those of today's voters.[3] On this issue, therefore, the interests of today's children have not been adequately protected by the political process—and a series of Presidents and Congresses have accumulated huge increments of perpetual debt, year after year. Today's children therefore look to the courts for protection.

3. THE FEDERAL POWER TO BORROW IS LIMITED BY THE CONSTITUTION'S PROTECTIONS OF INDIVIDUAL RIGHTS.

Congress, of course, has the power to borrow money on the credit of the United States.[4] But the federal borrowing power, like all other federal powers, is limited by the Constitution's individual rights protection—including the right to equal protection of the laws.[5] When perpetual debt is incurred, today's children are discriminatorily burdened.[6]

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[1] See Affidavit, 1 *Bonner v. Baker.*
[2] See Exhibit 1, *Bonner v. Baker.*
[3] See Affidavit 1, *Bonner v. Barker.*
[4] *Constitution,* Article 1, Section 8, Clause 2.
[5] *U.S. Department of Agriculture v. Moreno,* 413 U.S. 528 (1973).
[6] See Affidavit 1, *Bonner v. Baker.*

4. THE CURRENT SUSTAINED PATTERN OF MASSIVE FEDERAL BORROWING VIOLATES EQUAL PROTECTION STANDARDS RECENTLY ESTABLISHED BY THE COURT.

Governmental actions which discriminate against children must either bear a rational relationship to the relevant characteristics of children, or be supported by a "compelling governmental interest."[7] For such a rational relationship to exist, there must be something about today's children, as a class, to justify the discriminatory burdens these deficits impose upon them. Does massive federal borrowing protect them, as minors, from adult society? Does this borrowing protect adult society from the immaturity of children? Obviously not. Plainly, no rational relationship exists. Therefore, today's deficits must be supported by a compelling governmental interest in order to be constitutional.

Another reason deficits must meet the compelling governmental interest standard is that they deprive today's children of "fundamental" rights.[8] When (as has been the case over the last decade) federal deficits are huge and the cost of servicing the debt rises to one-fourth of federal tax revenues, the fundamental rights of children—including the right to vote and the right to a government capable of serving the enduring purposes of the Constitution—are endangered. In these circumstances, additional deficit financing must be supported by a compelling governmental interest.

The right to vote includes the right to make political choices which concretely affect the policies and actions of government.[9] When today's 50-year-olds reached voting age in 1953, they participated in a government in which less than 10 percent of revenues were spent on interest for old debts—debts almost entirely accumulated during World War II and other national emergencies which were in fact compelling government interests. By contrast, today's children, upon reaching majority, will participate in a government in which over 27 percent of federal tax revenues may be required for debt service. This means that over 27 percent of tax revenues will not be available for purposes decided on by the people, through the ballot box. As a result, future Congresses will have significantly fewer choices available to them than those of a generation earlier.[10]

5. CURRENT DEFICITS ARE NOT SUPPORTED BY COMPELLING (OR LEGITIMATE) GOVERNMENTAL INTERESTS

For all these reasons, the current sustained pattern of massive federal borrowing must be justified by some compelling governmental interest. The history of this nation suggests strongly that only military or economic emergencies meet this standard.[11]

From the initial days of the American Republic through World War II—and then, to a lesser and declining degree, through the early 1970's—American presidents and congresses borrowed only for military or economic emergencies. When the emergency ended, the borrowing ended—usually the next year, but always within two years (unless some other emergency intervened). Subsequent Presidents and Congresses made diligent efforts to retire a substantial part, and sometimes all, of the new debt principal.

None of these circumstances exist today. The current sustained pattern of massive federal borrowing, as followed since 1976, differs fundamentally from the principles established by the Framers and adhered to by every other generation of American leaders.[12] This pattern of behavior is unprecedented in its huge scale, in its lack of justification, in the government's inability to end it, in the lack of commitment ultimately to retire the new debt principal incurred, and in the large and permanent burdens imposed on generations to follow. There is simply no legitimate public purpose served by pushing such a large share of today's government onto tomorrow's taxpayers.[13]

When it comes to deficit financing, the nation's present generation of leaders has, over the past decade, sunk from the fiscal equivalent of "social drinking"—indulging in borrowing on a small scale, with an ostensibly valid purpose—to full-scale fiscal alcoholism. Today's leaders continue to indulge on a huge scale, for no valid

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[7] *City of Cleburne v. Cleburne Living Center*, 53 U.S.L.W. 5022, (July 1, 1985).
[8] *Harper v. Virginia Board of Elections*, 383 U.S. 663 (1966).
[9] *Reynolds v. Sims*, 377 U.S. 533 (1964).
[10] See Exhibit 1, *Bonner v. Baker*.
[11] See Tables 1-3. See also *Cleburne, supra; Hooper v. Bernalillo County Assessor*, 53 U.S.L.W. 4827 (1985); *Williams v. Vermont*, 53 U.S.L.W. 4655 (1985).
[12] See Exhibit 1, *Bonner v. Baker*, and *Ex Parte Quirin*, 317 U.S. 1 (1942).
[13] *Zobel v. Williams*, 457 U.S. 55 (1982).

purpose, and with effects they themselves know (and publicly state) will be destructive over time. But they can't stop themselves, and no one has yet succeeded in hiding the bottle.

We cannot expect an alcoholic to cure himself. Nor can we expect the Congress, on its own, to correct its ingrained borrowing habit in the face of overwhelming political pressures supporting the status quo.[14] That is why the newly enacted Balanced Budget and Emergency Deficit Control Act of 1985 (the "Gramm-Rudman-Hollings Amendment"), like earlier balance-the-budget promises and procedural reforms, cannot and will not stop this pattern of behavior.[15] The Congress can—as it has in the past with similar laws—amend, rescind, or supersede this new statute at any time.[16]

6. RELIEF SOUGHT

The seven child Plaintiffs—in a class action of behalf of all of America's 60 million children—ask the Court to declare the current sustained pattern of massive and unjustified federal borrowing an unconstitutional denial of the equal protection of the laws. They ask the Court to set a date certain for the elimination of this unlawful pattern of borrowing, and to set yearly deficit reduction targets in the interim.

The defendant, Treasury Secretary Baker, is only one of a great many public officials who is or may be responsible for the current pattern of governmental behavior. But he is the Executive Branch officer responsible for carrying out the unlawful program of borrowing. Accordingly, plaintiffs will ask the court permanently to enjoin the defendant from issuing any new instruments of indebtedness (other than to replace existing notes, on a dollar-for-dollar basis) which would contravene the standards set forth above.

For a copy of the Plaintiffs' complete 44-page legal memorandum (part of a request for class certification), formal complaint, and the Affidavits, Tables, and Exhibits noted above, please contact the National Taxpayers Union, 713 Maryland Avenue, N.E., Washington, D.C. 20002, (202) 543-1300.

PREPARED STATEMENT OF MICHAEL S. MARCH, PH.D.[1]

RESTORE FISCAL RESPONSIBILITY WITH SOCIAL EQUITY

Early reports on the first $11.7 billion of Gramm-Rudman automatic budget reductions for fiscal 1986 show that they will bite into the muscles of several important agencies such as the Internal Revenue Service. This is a foretaste of devastating cuts to come. To eliminate the present $220 billion annual deficits solely by budget cuts will mean further reductions 17 times as large as this first increment, all successively more deleterious to the mission of the U.S. Government.

The back-to-back combination of the Gramm-Rudman cut-the-budget amendment as signed by the President and the "revenue neutral" tax bill proposed by the President and passed by the House under the leadership of Chairman Dan Rostenkowski is not the right solution to the Government's budget problems. These two pieces of legislation do not deal realistically, adequately, or fairly with the fiscal crisis which besets our country. Our nation cannot afford the devastating social costs which this new set of Reganomic fiscal actions would require. This nation needs statesmanship in the Congress to restore our national finances sensibly to a healthy condition.

I believe that your Committee will find very few informed fiscal policy experts who would not support action to reduce the $220 billion annual Federal deficit. But a review on the facts relating to the deficit lead to the conclusion that the U.S. Government needs a tax bill which raises more revenues. It cannot withstand blind, meat axe budget cuts which fall indiscriminately on essential public programs which already have been hard hit by tens of billions of prior cuts. Moreover, in this time of huge deficits it would be national folly to give large tax rate cuts to well-to-do people who received disproportionately large tax reductions in the 1981 tax bill sponsored by our President. Such action would be a clear demonstration that this President and the Congress have no regard for the public interest.

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[14] *Baker v. Carr*, 369 U.S. 186 (1962).

[15] See Affidavit 2, *Bonner v. Baker*.

[16] Pub. L. 95-435 (1978), Pub. L. 96-389 (1981), and 31 U.S.C.A. Sec. 3101 (1984).

[1] Dr. March served as a fiscal analyst from 1944 to 1973 in the U.S. Bureau of the Budget and the OMB, Executive Office of the President, under six Presidents. Since 1973 he has been a Professor of Public Affairs at the University of Colorado, most recently in Denver.

There are several important factual points about procedure and substance which underlie the foregoing conclusions.

WHAT CAUSED THE ENORMOUS BUDGET DEFICITS?

During my quarter of a century in the machinery of the Presidency it became clear to me that in our Government the President must be the guardian of fiscal integrity and be the main molder of proper national priorities. Except in rare instances the Congress is not effective in protecting the Treasury. The Congress will cut taxes almost any time a President will let it. It is still ill-adapted to setting major priorities coherently.

President Reagan has taken advantage of these weaknesses in the makeup of the Congress to create huge deficits in his abortive efforts to dismember social and other domestic programs he and his supporters dislike. The result is that his policies are hurting the nation fiscally, economically, and socially. This is the time for the Congress to demonstrate that it can act decisively in the national interest!

Although as candidate Mr. Reagan held himself out as a fiscal conservative in 1980, his budget and tax policies as President can only be characterized as reckless. Very soon after entering the White House he submitted to the Congress a $1.6 trillion 5-year defense expansion program which has doubled the annual rate of military outlays. Instead of making provision for raising taxes to finance these exhaustive expenditures, Mr. Reagan simultaneously sponsored the largest tax reduction in our history—$750 billion over 5 years as enacted by the Congress with its added large liberalizations. That 1981 bill gave half of its tax reductions to the richest one-sixth of American households. Most of our nation's leaders and opinion shapers are undoubtedly in this favored group. Not only were they spared from paying their proper share of taxes for the increased defense outlays, they were given tax cuts!

This doubling of defense spending while cutting taxes sharply is the reason why the deficits under President Reagan have grown from $80 billion in 1980 to an estimated $220 billion in fiscal 1986. Indeed, my analysis of OMB and CBO data shows that for the Reagan years 1981-88 the cumulative deficits in excess of the 1980 rate closely parallel his increases in defense outlays plus the resultant increases in debt service. About 95 percent of the increase in budget deficits (and in the public debt) during these Reagan years is explained by the administration's failure to finance the burgeoning defense outlays on a pay-as-you-spend basis. My computation of the actuarial present value of future interest payments on the public debt thus incurred by President Reagan shows that the cost of his defense increases to the nation has been doubled because of this "credit card" method of financing.

Mr. Reagan's 1981 mistaken program is the reason why the U.S. Government debt has doubled to $2 trillion in the last 5 years, even with large cuts in domestic budgets which reached an annual rate of about $50 billion in 1984. CBO analyses of those cuts and of the 1981 tax bill reductions showed that the combined effect was extremely regressive. Is the nation ready for more of the same to cure the huge ongoing deficits resulting from the President's erroneous and misguided policies?

The deficits are in the "Federal funds" accounts ("general funds") which finance military and general government functions. The "Trust fund" accounts, including Social Security, Medicare, and Civil Service Retirement, in recent years have been collectively growing at a rate of around $50 billion yearly, thus offsetting the huge "Federal funds" deficits. (See 1986 Budget Special Analyses, p. C-8). As President Reagan himself has now repeatedly stated, Social Security does not create the budget deficit.

Despite its huge fiscal costs, Reaganomics has not produced the promised re-industrialization and other economic benefits. There is much evidence that these policies are at the root of high interest rates, the too-high rate of ongoing inflation which many observers believe will escalate, the growing burden of regressive interest payments from the Treasury, and the export deficit which has converted America into an international debtor nation. On the social side, budget cuts have hard hit the poor, the minorities, the children and youths, and especially the elderly whose benefit and health cuts run into the tens of billions and are continuing.

THE GROWING FISCAL CRISIS AND ITS IMPACTS

Now, in 1986, the President with considerable support in the Congress is using the excuse of the $200-billion-plus deficits, which his policies have created, to engineer further cuts in domestic budget programs to the "absolute minimum". Meanwhile, he is pressing the Congress to provide a continued 3% real rate of growth in the defense budget and simultaneously pushing the enactment of a "tax reform" bill

which will not produce any net revenue increase toward his deficit, which he blames on the Congress. Indeed, he threatens to veto any tax increase bill.

If no additional taxes are enacted and signed by the President, and the President and the Congress are not successful in agreeing on ways to reduce the deficit to meet the statutory Gramm-Rudman targets, automatic formula cuts will go into effect each year, to be shared 50/50 between defense and the rest of the unprotected part of the budget.

Given the recently estimated $220 billion figure for the deficit in fiscal 1986, as reduced by the automatic Gramm Rudman cuts of $11.7 billion now in process, the required reductions for fiscal 1987 would total between $50-$75 billion if the $144 billion target for the deficit in that year is to be met. The advance word is that the President's 1987 budget will propose massive reductions in domestic programs. There would still remain $144 billion in deficits to be eliminated in the next 4 years.

The options for cutting these deficits are (a) tax increases, (b) expenditure cuts in domestic programs as the President wants, and (c) increased revenues from economic growth. Low productivity and the indexing of the personal income tax, which started in 1985, severely constrict the possibility of substantial growth of revenues. If no tax increases are enacted, budget cuts approaching $100 billion each will have to be made in defense and domestic expenditures during the 5 fiscal years 1987-91 if Gramm-Rudman automatic cuts remain in force. If this happened, the President's national security build-up of the last 5 years would have to be substantially dismantled—and the same would happen to a large part of the social welfare and other domestic programs built up in the last 50 years. If all the $200-plus billion of the cuts were to be made in the domestic programs, incredible damage would be done to the human side of our society. In contrast to this enormous damage from budget cuts, the Reagan-Rostenkowski tax bill proposals to reduce present taxes for the rich, and especially to cut tax rates, appear ridiculously inappropriate and untimely. But these tax reductions for the rich are the very heart of second-term Reaganomics. They are intended to benefit the rich at the expense of the ordinary people and to shackle the Federal budget for years to come in a huge structural deficit which will make any attention to the social and human needs of the nation impossible. It is significant that the administration has not issued any forthright information on the impacts of the budget cuts—and on the distributional impact of the budget cuts and tax shuffles now under way. The Congress should insist on such factual information. Not just dollars and deficits are involved—people are deeply affected, especially people in the lower income classes who depend on Government aid.

In all of U.S. history never has the U.S. Government been thrust by its political leaders into such a deep, self-imposed, and crippling fiscal crisis. Never have policy decisions which could lead to the destruction of vital programs for human resources investment, for economic and infrastructure development, and for benefits and services for the dependent groups in the population which are so heavily dependent on the Government, been proposed, enacted, and even implemented without informing the Congress and the nation of the impacts and consequences of such action—or without even considering the needs of the people. The leaders of the U.S. seem to be on automatic pilot to destroy everything in the U.S. Government which is humane and socially responsible.

Apart from the forthcoming 1987 budget (which many in the Congress reportedly regard as dead before its arrival), two of the critical sets of decisions faced by the Congress revolve around the pending "tax reform" bill and the disposition of the mindless Gramm-Rudman process, perhaps by its repeal. These two sets of decisions are closely related, like the front and back of a coin.

THE HOUSE TAX BILL FAILS TO SERVE THE NEEDS OF THE NATION

The Reagan-Rostenkowski "tax reform" bill falls far short of the President's announced goals of "fairness, simplicity, and economic growth." It makes some progress toward achieving more equal treatment of taxpayers with equal incomes and levying minimum taxes on corporations and individuals. But these gains are more than offset by serious deficiencies in the House-passed bill, which basically follows the President's Reaganomic prescriptions.

The House tax bill fails to meet two governing criteria for a responsible tax bill, namely revenue adequacy for public needs and equity or equality of sacrifice among taxpayers with incomes which differ greatly. The latter principle supports progressive taxation at rates which equalize the marginal rate of sacrifice as incomes increase. More specifically, the House bill now before the Senate Finance Committee shortchanges the country in the following respects:

1. It turns its back on the key principle that the Government should raise enough revenues to cover expenditures deemed to be in the public interest. It does not meet the highest priority need of our nation in the present circumstances, which is for more revenue to reduce and eventually eliminate the irresponsible $200-plus billion annual deficits created during the first Reagan term.

These large structural deficits are exacerbated by the 1981 "tax COLAS" which began in calendar 1985 for individuals. The deficits are running at 5% of GNP. They are undermining our economy and our dollar, creating an ever-larger regressive public debt burden of non-productive outlays from the Treasury, and are strangling the vital social and general welfare activities of the Government.

It is not tax reform in these circumstances to follow the reckless 1981 tax reductions with a 1986 bill which raises no net revenue to cover the rampaging deficits—and which authorizes reductions in present tax rates for individuals and corporations costing $222 billion over the next 5 years. While such reductions may buy the allegiance of certain high-income groups by freeing them further from paying their proper share of taxes to support the growing defense effort, including the rapidly-growing Star Wars initiative, the public interest is not served by such cuts at this time. These rate reductions should be deferred by the Congress until the budget is balanced—and the savings should be earmarked specifically for reduction of the deficit. If the affected individuals and corporations are responsible, they will agree to this sacrifice.

2. The House bill provides net reductions in personal income taxes totaling $140 billion over the next 5 years. President Reagan and the House Committee on Ways and Means have repeatedly given out statistics which cause the public to think that the biggest cuts are for the poor—but the truth is that, as in 1981, these cuts are overwhelmingly for the rich.

Omitted from the thick House Report 99-426 on the bill are relevant distributional statistics which show that the average net personal tax reductions for the favored rich group are some 23 times as large as those for the numerous poor and lower middle income group. More exactly:

Three percent or fewer than 4 million individual tax units with incomes exceeding $75,000 a year would receive net personal tax cuts totaling $40 billion over the next 5 years. This is 30% of the total personal income tax reductions—while the President is proposing to rip the domestic programs for common people of this country to shreds on the grounds that the Government faces a crisis because of the deficits.

Within this group, the very rich whose incomes exceed $200,000 per year and who constitute only half of 1 percent of total tax returns would carry off some 14 percent of total personal tax reductions.

In contrast, 61 million returns constituting 51% of the tax population and having incomes under $20,000 annually would receive net personal tax reductions of $30 billion in 5 years, or just 22 percent of total personal tax cuts. They number 15 times as many as the 4 million in the rich group, but their overall dollar share is just ¾ that of the rich group. A great majority of the 27 million elderly over age 65 have adjusted gross incomes below $20,000—but the elderly have taken heavy budget program cuts.

Within the under $20,000 category the estimated tax returns with incomes under $10,000 a year number 34 million. The Ways and Means Committee has given wide publicity that their taxes were cut 76 percent on the average and that 6 million would be freed entirely of income taxes. What was not revealed was that the total tax reduction for these 34 million is only some $1.7 billion for 1987, an average of only $52 per annum per household. They have borne the horse's share of the budget cuts so far, but receive a rabbit's portion of tax benefits. The rich have been little affected by budget cuts, but their tax cuts are a horse's allowance.

The disproportionately large personal tax rate cuts for the top income brackets represent a wholesale retreat from the principle of progressive taxation on the basis of ability to pay and equal sacrifice among income brackets. The Reagan administration is not satisfied with the 1981 reduction of the top bracket rate from 70 percent to 50 percent; it seeks reduction in 1986 to a top rate of 35 percent—a large step toward flat rate taxation. Mr. Rostenkowski's bill, pushed through the House without a record vote, sets a 38 percent top rate. Our most equitable tax, the personal income tax, would thus be diminished in its progressivity and its revenue production in the Federal system. And this while we need the revenue very much.

The flattening of top rates for the personal income tax would give the taxpayers with incomes over $100,000 a year nearly twice as big a boost in aftertax incomes as that received by the under $10,000 group and two other middle income groups. The argument that top rate tax cuts will benefit the economy is conjectural. Where is

the evidence that the so-called incentive effects from cutting the top tax rates will be worth the loss in Federal revenues and will be more beneficial than the social losses from requisite budget cuts stemming from the revenue loss? Certainly, the low income people are still waiting for the benefits of the 1981 Reagan tax cuts to "trickle down" to them, witness the rates of poverty and unemployment.

As former OMB Director David Stockman stated while at OMB, "supply side" economics was just a convenient excuse to justify tax cuts for the rich. Since leaving OMB he has stated that the effort to cut social programs had shown that the nation wanted to keep them—and that the U.S. needs a $100 billion a year increase in taxes. Retention of the present personal and corporate tax rates would take us on the way to over 40 percent of his tax goal.

It should be noted that President Reagan's "tax reform" bill as submitted in 1985 provided much sharper cuts for the rich and much less for the poor than the Rostenkowski bill, which has the above regressive implications.

It has not surfaced in public debate, but the House bill's replacement of the 5-year personal tax reductions of $140 billion with tax increases in corporate income taxes totaling $139 billion represents a further major step toward a more regressive tax system. Inevitably a substantial proportion of the increased corporate income taxes would be passed through in price increases to consumers and have a regressive effect, much like a sales tax which hits low income people more heavily than the rich as a proportion of their incomes. This impact would hit the millions of the poor who get no benefit whatever from the proposed personal tax cuts.

The replacement of the personal tax cuts with increases in corporation taxes is an "iffy" proposition. It is being hotly contested by some business groups on the legitimate grounds that this will have a depressing effect on business capital investment—which was the Reagan administration and Congressional argument in 1981 for corporate tax reductions. A good deal of the present corporation tax increases now being attempted represents a withdrawal of 1981 and earlier excessive and nonproductive "tax expenditure" benefits to business.

Unfortunately for tax equity, even more regressive alternatives than the corporate income tax are being discussed in the Congress and the administration: Increased gasoline or energy taxes and/or a value added or a transactions tax. These would all be buried in the cost of goods and services and would be far more regressive than the present personal income taxes, especially if the latter were left at present rates and adjusted to close loopholes. It will be up to the Congress to protect the ordinary people of America from the Reagan administration's effort to foist new forms of hidden, regressive, consumption taxes on the American public while it cuts personal income taxes for the rich by wagonloads.

The Reagan administration is also pushing the whole Federal-state-local fiscal system into a more regressive mode. This is the prime consequence of the elimination of Federal equalizing grants which are financed by somewhat progressive Federal taxes, which grants are not replaced by state or local governments or, if replaced, are financed by generally quite regressive local taxes or by state taxes which are less progressive than Federal taxes. Moreover, the administration has sought to double tax state and local government funds by denying state and local taxes as a deductible item in computing Federal personal income taxes so, in effect, people would pay taxes to the Federal Government on their state and local taxes. The Rostenkowski bill continues the deductibility of such taxes, but the issue will be fought in the Senate.

THE BUDGET CUTBACK ROUTE TO COVER THE DEFICITS WOULD DAMAGE THE NATION

Congressional assessment of the legitimacy and feasibility of eliminating the $220 billion Federal deficit through budget spending reductions must start with consideration of the background of the problem.

When he announced for the Presidency in November 1979, Mr. Reagan castigated previous Presidents for their economic "disaster" because their deficits ("printing press money" he said) had totaled $448 billion in the 34 years since World War II had ended. In his first 5 years President Reagan ran up deficits which have more than doubled the public debt of $916 billion when he took office.

In his "America's New Beginning: A Program for Economic Recovery", February 18, 1981, President Reagan presented to the Congress a Budget Reform Plan which projected a small budget surplus for fiscal year 1984. His 1986 Budget (p. 9-60) reported an actual deficit of $175 billion for 1984, plus $10 billion more in off-budget deficit.

In his "New Beginning" document Mr. Reagan represented that his budgets would run surpluses after fiscal 1984 even though his plan included the largest tax cut in history of this country.

In actuality, his tax cut as enacted in 1981 has, by his own estimates in the 1986 Budget (p. 4-4), caused reduced revenue collections ranging from $168 billion in fiscal 1985 to a projected $283 billion in 1988. His budget deficits for 1985 and 1986 exceed $200 billion a year.

In his "New Beginning" document Mr. Reagan laid out his 5-year $1.6 trillion defense plan, but without providing revenues to cover the projected doubling of expenditures. Indeed, he sponsored the largest tax cut in history. His 1986 Budget shows an increase in nation defense expenditures from $134 billion in fiscal 1980 to an estimated $286 billion for 1986. (p. 9-48)

In his "New Beginning" document Mr. Reagan promised "adequate funding of essential social safety net programs, including cost-of-living protection for the elderly." (p. 8) But even in 1981 budget cuts were made in "safety net" programs, huge cuts were proposed in Social Security in 1981 and 1983—and in 1983 COLA denials and other changes were made in Social Security which are depriving recipients of some $10 billion a year by continuing benefit reductions. Medicare, also included in the original Safety Net, has been cut by many billions and continues to be a big target of further reductions. By the end of 1984 domestic programs had been reduced by some $50 billion annual rate, the great bulk from social benefit and human investment programs such as health and education. COLA's are being denied to Federal retirees.

Several conclusions emerge from a review of the Reagan record:

1. His promises, projections, and statements are unreliable.

2. This President is responsible for having wrecked Federal finances on a scale equalled by no prior President.

3. This President's program is based on ideology, not on facts. Based on what he has proposed and done as President, his goals are to: Redistribute Federal tax and budget resources to the rich and to take them from the poor and lower middle classes. Reduce taxes, especially for the rich, as a way of forcing cutbacks in Federal spending for domestic and particularly social programs. Increase military spending and do so by cutting social programs. Fortunately, the Federal Government as it has evolved in the last 50 years has a much greater regard for the compassionate and humane treatment of deprived and dependent people than President Reagan's philosophy envisions. His goals, as a practical matter, would destroy the U.S. Government's role in promoting the general welfare and the public health, safety, and welfare.

4. President Reagan and his associates are very able in bluffing the Congress in pursuit of his ideological goals—but when he sees that he clearly lacks the votes, he does back off and compromise. The fiscal mess he has created is now so serious and so evident, his 1987 budget cut proposals are so ridiculously unreasonable and damaging to the fabric of necessary Government, and his "tax reform" proposals are so out of line with the harsh necessity of replacing or restoring some of the reckless tax cuts made in 1981, that Mr. Reagan's 1986 program must be restructured by Congressional leaders, Republicans and Democrats working side by side, into a more reasonable set of proposals so the U.S. Government can continue to serve the American people.

5. A key defect in President Reagan's thinking is that the national Government is not useful or even necessary, except to defend the country. He is wrong. The Government provides the foundation of laws, rules, and programs on which the private economy is built. The social and regulatory programs are vital for the health, economic security, financial security, and the protection of every American. It is the responsibility of the Congress to protect the system of Government which enables our society and our economy to function.

The implementation of the Gramm-Rudman cut-the-budget provisions would severely damage the U.S. Government if the Reagan-Rostenkowski tax bill is enacted without changing it to raise substantial revenues. Some examples of the results include:

If the automatic cuts continue to be divided 50/50 between defense and domestic programs, so reductions of over $100 billion are made in each of them from 1987 to 1991, the Reagan defense build-up will be largely wasted, but at the same time the domestic programs will be devastated even more because they are already reduced.

If Gramm-Rudman is changed to impose the cuts solely on domestic and social programs, they will be damaged so severely that the "people" programs of the Government will be rolled back toward the 1930's—much like the status of a third world country as far as social protection. Millions of the elderly will be reduced to

poverty, lose their health benefits, and be denied hospital and nursing home care. Children likewise.

The first step the Congress should take is to demand explicit information from the President on what the effects of Gramm-Rudman would be by 1991.

Gramm-Rudman would cripple the U.S. Civil Service and make a Federal career completely unattractive. Civil Service retirees were the first to lose their COLA's. Their median annuities are just $966 a month and survivors receive only $423—but the U.S. Government has reneged by violating a permanent law enacted in 1962 to provide inflation protection to retired employees who had spent their lives in work paid well below private sector rates.

Active Civil Servants are to be denied a pay increase at a time when private workers, who are already higher paid, are in line to 6 percent raises and business executives have been getting 11 percent. Worse yet, some 200,000-350,000 Federal employees could lose their jobs by 1991. The Civil Service is the backbone of the U.S. Government. Does the President want to destroy the career service? Do the President and Congress intend to continue reneging on Civil Service Retirement benefits by amending provisions after workers have retired in reliance on duly-enacted statutes of the U.S. Government? Can anyone trust this Government to discharge its statutory obligations to its workers or retirees who earned rights by serving under contributory plans?

Gramm-Rudman is the opposite of a proper and sensible method for budgeting public resources:

a. The amendment was whipped through the Congress without public hearings.

b. The Federal agencies, the Congress, and the public were not advised, before its passage and Presidential signature, what its impacts and consequences would be.

c. It violates every rule of sound budgeting and subverts rational budgeting by creating a mindless, "no hands", formula-directed process for cutting the budget by flat percentages clear down to small activities. There is no weighing of benefits vs costs, or of the relative worth of programs in apportioning reductions. Quick-spend appropriation accounts are hurt disproportionately because of slow-spend accounts in the computation of the cut-back percentage.

d. It deals with spending cuts, not with the trade-off between cuts and tax increases, in its process. Implicitly, it proposes to eliminate deficits in their entirety by expenditure cuts, without considering that imprudent, manipulative actions may have caused the deficits.

e. The constitutionality of the amendment is in doubt, raising further questions whether this amendment also makes inroads into existing provisions for open and responsible fiscal decisionmaking.

f. Gramm-Rudman is a big step away from clear separation of executive and legislative duties and functions in the budgeting and taxing fields in which the public can determine who takes what action and can hold the President and members of the Congress responsible and accountable for their particular actions. It also bundles diverse programs together to be handled mechanically, by formula, whereas the decisions being made are actually of a policy nature and ought to be handled separately in many cases and voted on separately by the Congress.

Gramm-Rudman is contrary to the practice and spirit of the fiscal decision-making processes in the Federal Government as they have been and ought to be practiced. The Congress ought to repeal this ill-considered, Reaganomic amendment, over the President's veto, if needed.

SOLVE THE CRISIS BY FISCALLY RESPONSIBLE AND EQUITABLE MEANS

The crisis over $220 billion Federal deficits cannot be solved by budget cuts. The source of the problem is that huge tax cuts were made in 1981 simultaneously with huge increases in defense spending. Domestic programs have already been hurt by budget cuts—to cut more will hurt millions of people who need and deserve help in this economy which produces $16,000 of GNP per capita annually.

In the first Reagan term budget cuts for the poorer people and tax reductions for the rich redistributed national resources from the poor toward the rich. Even larger budget cuts for fiscal 1986 and 1987 are again aimed at the poor and the middle class; and the Reagan-Rostenkowski "tax reform" bill gives the rich big tax cuts while hitting the poor and the middle class with more taxes once we consider the pass-through of corporate and possible other consumption taxes. This process will shove the poor deeper into desperation, shrink the middle class some more, increase the concentration of income and wealth in the hands of the very rich—and in the end undermine our democracy. The Congress has a solemn public responsibility to halt this destructive set of changes in our society. Bi-partisan action is needed.

The Federal budget can be restored to a reasonably balanced basis step by step over the next 5 years by carrying out normal, rigorous budget review of defense and domestic spending and by reshaping the pending tax bill to raise revenues by successive increments of $50 billion for 3 years so $150 billion will be raised by 1989.

The modified tax bill To Promote Fiscal Soundness and Equity in Taxation would substitute closing of major, inequitable loopholes as identified by the administration and the Ways and Means Committee for the pending extensive "reform" bill. In a real sense the proposed bill would make the reforms most pertinent to solving the budget crisis—namely, raising needed revenues and closing loopholes to increase distributional equity by:

1. Retaining existing tax rate schedules for corporate and personal income taxes, with adjustment of the standard deductions and earned income credits for low-income people to compensate for inflation.
2. Implementing effective, inescapable minimum taxes of, say 20 percent, for higher income individuals and corporations where assorted loopholes are used to escape or minimize taxes, e.g., the special defense exclusion.
3. Repealing the wasteful Investment Tax Credit and tightening the treatment of depreciation allowances along the lines of H.R. 3838.
4. Repealing the indexing of individual income taxes to reduce the structural deficit and enhance countercyclical stabilization.
5. Restricting tax subsidies for IRAs, income deferment plans, private pensions, etc., in which the proceeds are payable as supplements to the basic Social Security payments. Make restrictions prospective by capping deductible contributions by high earners.
6. Repeal the tax exemption on municipal bonds for industrial purposes; raise capital gains taxes; and levy a national defense surtax on higher individual and corporate incomes.

[Whereupon, at 12:28 p.m., the hearing adjourned.]

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